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IN THE

**United States Court of Appeals**

**For the Ninth Circuit**

ARISTA CIA. DE VAPORES, S.A.,

*Appellant,*

vs.

HOWARD TERMINAL,

*Appellee.*

**BRIEF FOR APPELLANT**

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**FILED**

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No. 20,872

IN THE

**United States Court of Appeals  
For the Ninth Circuit**

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ARISTA CIA. DE VAPORES, S.A.,

*Appellant,*

vs.

HOWARD TERMINAL,

*Appellee.*

---

**BRIEF FOR APPELLANT**

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**JURISDICTION**

Jurisdiction of this Court exists, by virtue of 28 U.S.C. § 1291 and a Notice of Appeal (R. 83), filed January 27, 1966, from a Judgment (R. 78) in admiralty entered in the United States District Court for the Northern District of California on November 8, 1965.

The District Court had jurisdiction, under 28 U.S.C. § 1333, by virtue of a longshoreman's libel against Appellant for an injury incurred on Appellant's vessel on navigable waters and an impleading petition filed by Appellant against Appellee seeking indemnity under a stevedoring contract (Stipulation, R. 65).



### STATEMENT OF THE CASE

This case was commenced in the Court below by a longshoreman's Libel to recover from Appellant shipowner for injuries suffered while working aboard Appellant's vessel, the SS WORLD LEADER. The vessel owner impleaded the longshoreman's employer, Howard Terminal, seeking indemnity for the expense to which it was put by reason of the longshoreman's action. The longshoreman's claim was resisted by the shipowner and prepared for trial and, when the case was called for trial, the longshoreman voluntarily dismissed his Libel, leaving before the Court only the claim presented in the Impleading Petition to recover the expense of the shipowner's successful defense.

The case was submitted to the Court below on a Stipulation of facts (R. 65) as follows:

"1. The vessel, SS WORLD LEADER, a Liberty type vessel, was owned and operated by ARISTA CIA. DeVAPORES, hereinafter referred to as 'Owner';

"2. HOWARD TERMINAL, a corporation, hereinafter referred to as 'Howard' is an expert stevedoring contractor, well experienced in the loading of scrap metal in vessels;

"3. On May 1, 1962, Howard was conducting stevedoring operations on the vessel, loading scrap metal into the No. 5 hold;

"4. Howard was performing its stevedoring services in accordance with a standard oral contract for such services;

"5. COESCO LOCKETT was employed as a longshoreman by Howard in this operation;

“6. At about 10:00 A.M. on May 1, 1962, Lockett, while walking backward over the deck of the vessel, tripped over a steam pipe guard, which is a standard part of the structure of all Liberty type vessels (a photograph of the area is attached [to the Stipulation, at R. 68] as Exhibit ‘A’);

“7. The Owner was not negligent in causing Lockett’s accident;

“8. The vessel was seaworthy in all respects with reference to Lockett’s accident;

“9. Lockett was negligent in causing his own accident, and his negligence was the sole proximate cause of his accident;

“10. On April 15, 1963, Lockett filed a Libel in Admiralty against the Owner, seeking damages from the Owner because of certain negligence and unseaworthiness alleged therein;

“11. It was reasonable and necessary for the vessel to defend itself against the Libel filed by Lockett up to the moment that Lockett’s Proctor moved the Court that the case be dismissed;

“12. The Owner incurred certain reasonable and necessary Proctors’ fees and expenses in defending the Owner against the Libel filed by Lockett, the exact amount of which is yet to be determined, and will be the subject of a further hearing by the Court, if not hereafter stipulated by the parties;”

Despite the stipulation that an employee of the stevedore (the libelant himself) had been negligent in causing Libelant’s injuries, the District Court decided, in a Memorandum Opinion and Judgment (R. 78), that the stevedore did not breach its warranty of safe and proper



performance and that the vessel owner was therefore not entitled to recover its damages. The District Court reached this result by testing breach of contract not as of the time of negligent performance aboard the vessel but as of the time of the unmeritorious suit ("In order to recover over the costs of the legal defense, the Shipowner must prove that the Stevedore breached his warranty of workmanlike service when his employee brought the unmeritorious personal injury suit." Memorandum Opinion, at R. 79). The Court supported its decision with a policy argument that the filing of such a suit should not be discouraged (R. 82).

This appeal presents the question whether carelessness on the part of a stevedore's employee ceases to be a breach of the stevedore's warranty of safe and proper performance because it results in injury to the careless employee, rather than to another, and whether the shipowner is barred, on account of that distinction, from recovering the damages which it incurs because of the resulting longshoreman's injury suit.

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### **SPECIFICATIONS OF ERROR**

The following errors are relied upon by Appellant:

1. The District Court erred in holding that the negligence of Libellant, the Appellee's employee, was not a breach of Appellee's warranty of safe, proper and workmanlike performance.

2. The District Court erred in holding that Appellant was not entitled to recover from Appellee the expenses

of Appellant's successful defense of an action brought against it by Appellee's employee, resulting from negligence in the performance of Appellee's stevedoring contract with Appellant.

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### SUMMARY OF ARGUMENT

It is settled doctrine that stevedore contractors are liable, under their warranties of safe and proper performance, to reimburse shipowners for the expenses of the longshoremen's injury suits which arise from their negligent performance, not only where the shipowner has had to pay damages to the longshoremen, but also where he has not done so, as when the stevedore contractor secures the dismissal of the suit or the shipowner successfully defends against it.

In denying indemnity here on the ground that there had been no breach of warranty, the Court below mistakenly tested for breach of warranty at the time of suit, rather than the time of performance of the contract, misconstrued contrary decisions in other Circuits and based its decision upon a policy argument against discouraging longshoremen's suits which had been rejected by the Supreme Court in its application to meritorious claims and is applied here only to encourage unmeritorious ones.

The decided cases show a clearly established rule of allowing the recovery of defense expenses from the stevedore whether the injury results from unseaworthiness which the longshoreman alone has created or simply from his own inattention to his own safety or from the negli-



gence of one or more of his fellow employees and whether or not the case is successfully defended, as this rule imposes the expense upon the party best able to promote safety and prevent the injury and encourages the effective defense of such suits by the shipowner. The disallowance of indemnity in the present case would be contrary to the prevailing views in other Circuits and create an anomalous exception to the rule, unsupported by policy.

The Supreme Court has stated the policy in these cases to be that the burden should fall upon the stevedore, who is best situated to encourage safety on the part of longshoremen. The rule announced by the Court below would put a premium on losing lawsuits by placing the shipowner in a worse position from defending effectively, than he would be in, if he settled or suffered the judgment to go against him. The policy argument that the allowance of indemnity might result in discouraging the bringing of suits such as this was rejected by the Supreme Court in its application to meritorious claims. The implication of such an argument in the present case is that unmeritorious claims are to be encouraged where meritorious ones may be discouraged. Such is not the policy of the law.

## ARGUMENT

- I. THE CARELESSNESS OF A STEVEDORE'S EMPLOYEE WHICH CAUSES AN INJURY IS A BREACH OF THE STEVEDORE'S WARRANTY OF SAFE AND PROPER PERFORMANCE WHICH ORDINARILY GIVES RISE TO A DUTY OF THE STEVEDORE TO RESPOND IN DAMAGES FOR THE EXPENSE TO WHICH THE SHIPOWNER IS PUT BY THE RESULTING LAWSUIT.

Since the decision in *Seas Shipping Company v. Sieracki*, 328 U.S. 85, 1946 A.M.C. 698, it has become the rule rather than the exception that a longshoreman's injury results in a claim against the shipowner.<sup>1</sup> In *Ryan Stevedoring Co. Inc. v. Pan-Atlantic Steamship Corporation*, 350 U.S. 124, 1956 A.M.C. 9, under the growing pressure of such longshoremen's claims, it was held to be an implied term of a stevedore contract that the stevedore would perform safely, properly and in a workmanlike manner and was obliged to pay as damages the expenses incurred by the shipowner as the result of such suits arising from a breach of the warranty. There is such a breach, of course, whenever the longshoremen employed by the stevedore fail to exercise proper care for their own and each other's safety, as when they fail to look where they are going or choose an unsafe route instead of a safe one. *Nicroli v. Den Norske Afrika, etc.*, 332 F.2d

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<sup>1</sup>"Indeed, in an action by one injured aboard a vessel, whether in or out of navigation, it is difficult to conceive of any situation wherein there would not be some *potential* liability upon the shipowner if the injured party was engaged in the performance of any work connected with the vessel." *Bielauski v. American Export Lines v. Norfolk Shipbuilding & Drydock Corporation*, 220 F. Supp. 265, 270, 1964 A.M.C. 984, 991 (E.D. Va. 1963) *aff'd sub nom. American Export Lines v. Norfolk Shipbuilding & Drydock Corporation*, 336 F.2d 525, 1965 A.M.C. 167 (4th Cir. 1964).



651, 1964 A.M.C. 1413 (2d Cir.); *Mortensen v. A/S Glittre*, 348 F.2d 383, 1965 A.M.C. 2016 (2d Cir.); *Lusich v. Bloomfield Steamship Company*, 355 F.2d 770, 1966 A.M.C. 191 (5th Cir.).

The damages recoverable by the shipowner from the stevedore under the *Ryan* warranty include not only the amount paid to the injured longshoreman but also the shipowner's attorneys' fees and other expenses in defending against the longshoreman's claim. *Matson Terminals, Inc. v. Caldwell and Sea-Land Service, Inc.*, 354 F.2d 681, 1966 A.M.C. 624 (9th Cir. 1965). This is true not only when the longshoreman's claim proceeds to judgment but also when it is settled by the shipowner. *Shannon v. United States*, 235 F.2d 457, 1956 A.M.C. 2281 (2d Cir.); *Damanti v. A/S Inger*, 314 F.2d 395, 1963 A.M.C. 852 (2d Cir.). Moreover, it is well established that, when a breach of warranty has led to an injury suit against the shipowner, the owner is entitled to recover the fees and expenses for its defense from the stevedore, even though it has not been required to pay anything by way of damages to the longshoreman. This is the case where the longshoreman agrees with the stevedore to withdraw his claim against the shipowner, as in *Paliaga v. Luckenbach Steamship Company*, 301 F.2d 403, 1962 A.M.C. 1632 (2d Cir. 1961) and *Rederi A/B Dalen v. Maher*, 303 F.2d 565, 1962 A.M.C. 1944 (4th Cir.). And it is so where the shipowner is successful in defeating the longshoreman's claim at trial. *Massa v. C. A. Venezuelan Navigacion*, 332 F.2d 779, 1964 A.M.C. 1375 (2d Cir.); *Guarracino v. Luckenbach Steamship Company*, 333 F.2d 646, 1964 A.M.C. 2240 (2d Cir.); *Ellerman Lines v. Atlan-*

*tic and Gulf Stevedores, Inc.*, 339 F.2d 673, 1965 A.M.C. 283 (3d Cir. 1964); *American Export Lines v. Norfolk Shipbuilding & Drydock Corporation*, 336 F.2d 525, 1965 A.M.C. 167 (4th Cir. 1964); *Strachan Shipping Co. v. K.N.S.M.*, 324 F.2d 746, 1964 A.M.C. 3 (5th Cir. 1963).

The imposition of liability upon the stevedore in all these cases falls within the policy stated by the Supreme Court, in *Italia Societa per Azioni di Navigazione v. Oregon Stevedoring Company*, 376 U.S. 315, 324, 1964 A.M.C. 1075, 1082, that "liability should fall upon the party best situated to adopt preventive measures and thereby to reduce the likelihood of injury."

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**II. THE FACT THAT THE SHIPOWNER SUCCEEDS IN DEFENDING THE CASE BY ESTABLISHING THAT THE LONGSHOREMAN WAS INJURED THROUGH HIS OWN NEGLIGENCE IS NO REASON FOR DEPARTING FROM THE RULE AND DENYING RECOVERY OF THE EXPENSES OF DEFENSE.**

**A. The Decision Below**

In the present case the shipowner successfully defended the longshoreman's injury claim to the point of securing a voluntary dismissal at the opening of trial. Although the longshoreman claimed otherwise, it was agreed, as between the shipowner and stevedore, for the purposes of this indemnity claim, that the vessel was seaworthy and her owners not negligent and that the plaintiff's own negligence was the cause of his injury (Stipulation, R. 65, 66). In denying recovery of indemnity for the admitted negligence of the stevedore's employee, the Court



below mistakenly tested for breach of warranty by looking for it at the time suit was brought rather than when the stevedoring was performed, ignored and misconstrued prior Court decisions and based its decision upon a statement of policy which had already been rejected by the Supreme Court of the United States.

The Court below got off course early in its Memorandum Opinion and Judgment (R. 78, at 79) when it said, "In order to recover over the costs of the legal defense, the Shipowner must prove that the Stevedore breached his warranty of workmanlike service when his employee brought the unmeritorious personal injury suit. *Massa v. C. A. Venezuelan Navigacion . . .*" A reference to any of the other indemnity cases cited in this brief will show that the test applied for workmanlike service has nothing to do with the time when suit is brought but depends upon proper performance when, and only when, the stevedoring operations aboard ship are underway. The case of *Massa v. C. A. Venezuelan Navigacion*, 332 F.2d 779, 1964 A.M.C. 1375 (2d Cir.) not only gives no support for the proposition for which it was cited, but stands in direct conflict with the ruling of the Court below.

With respect to holdings outside this Circuit, the Court below had this to say: "The courts outside the Circuit which have touched the specific question of reimbursement of attorney's fees in an unsuccessful lawsuit against the shipowner, have done so mainly by way of dictum." (R. 80). The Court goes on to mention two of the cases, the *Strachan* case and the *Guarracino* case, which involved this problem. In fact, the Courts of Appeals in the Second, Third, Fourth and Fifth Circuits have all dealt

directly with the question referred to and have held the shipowner entitled to recover, in terms which were by no means dicta. *Massa v. C. A. Venezuelan Navigacion*, 332 F.2d 779, 1964 A.M.C. 1375 (2d Cir.); *Guarracino v. Luckenbach Steamship Company*, 333 F.2d 646, 1964 A.M.C. 2240 (2d Cir.); *Ellerman Lines v. Atlantic and Gulf Stevedores, Inc.*, 339 F.2d 673, 1965 A.M.C. 283 (3d Cir. 1964); *American Export Lines v. Norfolk Shipbuilding & Drydock Corporation*, 336 F.2d 525, 1965 A.M.C. 167 (4th Cir. 1964); *Strachan Shipping Co. v. K.N.S.M.*, 324 F.2d 746, 1964 A.M.C. 3 (5th Cir. 1963).

The Court below appeared to see a distinction between this case and "situations in which there was either unseaworthiness on the part of the vessel . . . negligence on the part of a fellow employee, or a lack of supervision by the Stevedore company." (R. 80). The Court recognized, moreover, that if the negligence of the longshoreman had resulted in breaking a piece of ship's gear, as well as injuring himself, the warranty would be breached (R. 81).

Laying great stress on the fact that the longshoreman's claim has been found to lack merit, the Court went on to state that "the Shipowner (like all other property owners) must accept the burden of defending himself against unmeritorious claims of workman [sic] invited on his premises and cannot look to the stevedore for reimbursement." (R. 82). This is the "cost of doing business" argument of which one court said: "Patently, this is not a *reason* for denying recovery of the costs of litigation over against the third party defendant stevedore; this is no more than the restatement of the courts' conclusion

denying recovery''. *Caswell v. K.N.S.M.*, 205 F.Supp. 295, 297, 1962 A.M.C. 2126, 2128 (S.D. Tex.) aff'd *sub nom. Strachan Shipping Co. v. K.N.S.M.*, 324 F.2d 746, 1964 A.M.C. 3 (5th Cir. 1963).

Finally, the Court below puts forth the policy argument that "If the court were to decide otherwise, undue pressure might be put on longshoremen by their employers to accept compensation rather than sue the shipowner and run the risk of incurring legal defense fees which the Stevedore company or Contractor would ultimately have to pay''. (R. 82). Precisely this argument was stated by the dissenters in *Ryan Stevedoring Co., Inc. v. Pan-Atlantic Steamship Corporation*, 350 U.S. 124, 144, 1956 A.M.C. 9, 25, and was much more appropriate in the *Ryan* case, where it was rejected in its application to meritorious suits, than here, where it is accepted in its application to those which are unmeritorious.

## **B. The Decided Cases**

The stevedore is held for damages on its warranty where the injury was caused by unseaworthiness which the injured longshoreman himself alone created, as in *Holley v. The Manfred Stansfield*, 186 F.Supp. 212, 1960 A.M.C. 1956 (E.D. Va.), or knowingly allowed to continue, as in *Mortensen v. A/S Glittre*, 348 F.2d 383, 1965 A.M.C. 2016 (2d Cir.). Likewise, by simple carelessness and inattention to his own safety, apart from the creation of any condition of unseaworthiness, the longshoreman breaches the stevedore-employer's warranty and subjects the stevedore to damages. *Nicroli v. Den Norske Afrika, etc.*, 332 F.2d 651, 1964 A.M.C. 1413 (2d Cir.); *Lusich v.*



*Bloomfield Steamship Company*, 355 F.2d 770, 1966 A.M.C. 191 (5th Cir.).<sup>2</sup> In the *Nicroli* case the court said:

“Moreover the plaintiff’s own negligence in failing to watch where he was going and in taking an unsafe route when he knew that a safe route was available would be sufficient to charge the stevedore with breach of its warranty of workmanlike service.” 332 F.2d at 656, 1964 A.M.C. at 1420.

The negligence of the plaintiff operates with the same effect, and surely with even greater reason, in the cases where it is used as the basis of a successful defense by the shipowner. Of the cases of successful defense which we have already cited,<sup>3</sup> the three which we next refer to involve that very problem.

In *Damanti v. A/S Inger*, 314 F.2d 395, 1963 A.M.C. 852 (2d Cir.), the longshoreman’s claim was settled by the

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<sup>2</sup>There is an obscure reference in the District Court’s opinion (Footnote 1, at R. 81) to *Drewery v. Daspit Bros. Marine Divers, Inc.*, 317 F.2d 425, 1963 A.M.C. 1787 (5th Cir.), where the injured man’s own negligence was held not to impose liability upon his employer. In the *Lusich* case, cited in the text above, the same court distinguished the *Drewery* case as involving the construction of a particular written contract provision.

<sup>3</sup>In addition to the *Damanti*, *Massa* and *Guarracino* cases discussed in the text at this point, *Ellerman Lines v. Atlantic & Gulf Stevedores, Inc.*, 339 F.2d 673, 1965 A.M.C. 283 (3rd Cir. 1964); *American Export Lines v. Norfolk Shipbuilding & Drydock Corporation*, 336 F.2d 525, 1965 A.M.C. 167 (4th Cir. 1964) and *Strachan Shipping Co. v. K.N.S.M.*, 324 F.2d 726, 1964 A.M.C. 3 (5th Cir. 1963), also cases in which indemnity was allowed for the expenses of successful defense, have already been cited. The *Ellerman* case arose on pleadings and the holding with respect to the recoverability of successful defense expenses is unqualified. In the *American Export Lines* case the sole proximate cause of the accident was the negligence of plaintiff’s co-employee. In the *Strachan* case there was unspecified stevedore negligence.

shipowner prior to judgment and the indemnity claim was submitted to a jury on special interrogatories. The jury found that there had been no unseaworthiness of the vessel or negligence of her owners (and hence no vessel liability) and that the injury was caused by stevedore negligence only but that the shipowner had acted reasonably in settling the case. Based upon that verdict the District Court denied recovery of the defense expenses. The Court of Appeals, in reversing, stated:

“It is probable that the negligence of the stevedore . . . was based solely on the actions of the injured longshoreman. This, however, does not preclude recovery over by the shipowner, but is simply a factor that would reduce the recovery of the injured plaintiff from him. . . . and thus is to be considered only in determining the reasonableness of the settlement.”  
314 F.2d at 399, 1963 A.M.C. at 857.

In *Massa v. C. A. Venezuelan Navigacion*, 332 F.2d 779, 1964 A.M.C. 1375 (2d Cir.), the vessel was found seaworthy and her owner free of negligence and the accident was found to have been caused by the negligence of the plaintiff himself and a fellow longshoreman, in the manner in which they jointly connected their lifting equipment to a pallet board. Although the only negligence was that of the plaintiff or other negligence precisely like it, and the suit was therefore successfully defended as unmeritorious, indemnity for the expenses of defense was granted. In discussing the unmeritorious character of the suit, the Court stressed that whenever the stevedore has caused “potential loss to the shipowner by rendering it likely to suit, the stevedore has breached its

warranty . . .” 332 F.2d at 782, 1964 A.M.C. at 1379, and went on to say:

“[W]e see no good reason for forcing the shipowner to bear the expenses of successfully defending the suit when the stevedore would have to bear the shipowner’s expenses of unsuccessfully defending the suit. Such a rule would place a premium on losing law suits.” 332 F.2d at 782, 1964 A.M.C. at 1379.

The Court pointed out that:

“The burden is best placed on the stevedore who can minimize expense and injury by insisting on greater safety precautions.” 332 F.2d at 782, 1964 A.M.C. at 1380.

In *Guarracino v. Luckenbach Steamship Co.*, 333 F.2d 646, 1964 A.M.C. 2240 (2d Cir.), there was likewise found no unseaworthiness or vessel negligence. The accident was found to be due solely to the injured man’s having attempted to climb out of a hold on some cartons without waiting for a portable ladder and to the failure of the hatch boss to stand guard and prevent the plaintiff from climbing up until the ladder was brought. The Court of Appeals stressed that the warranty had been breached, and liability thus imposed, in two separate respects, one of which was the injured man’s own negligence, saying:

“While the shipowner has been successful in defense of the main action, he has suffered loss, in the form of attorney’s fees and expenses in the defense, caused by the actions of the stevedore’s employees in two respects which we hold were in breach of the stevedore’s warranty of workmanlike service. These are the abandonment of his post by the hatch boss in the



face of his general instructions to stay at a hatch until a ladder was brought, and the action of libellant, when a safe alternative was available, in taking a way out likely to cause injury to himself and his fellow worker.” 333 F.2d at 648, 1964 A.M.C. at 2242.

Again the Court of Appeals pointed out the sound policy of this result, saying:

“This is as it should be, for it is the stevedore, in direct control of the hatch boss and the worker, who can best avoid the injury and expense by insistence on observance of safety precautions.” 333 F.2d at 648, 1964 A.M.C. at 2243.

If the longshoreman, in falling, had not only injured himself but damaged a piece of ship’s gear, it appears that the Court below would agree that the warranty was breached (R. 81). Likewise it appears that if the sole negligence of one longshoreman had injured another longshoreman, as in *American Export Lines v. Norfolk Shipbuilding & Drydock Corporation*, 336 F.2d 525, 1965 A.M.C. 167 (4th Cir. 1964), or the joint negligence of two longshoremen had combined to injure one of them, as in *Massa v. C. A. Venezuelan Navigacion*, 332 F.2d 779, 1964 A.M.C. (2d Cir.), there would be no issue presented here as to the existence of a breach of warranty.

In summary, if Lockett, the longshoreman, in falling, had done property damage, it would have to be paid for by the stevedore; if he had struck another longshoreman and caused him to fall at the same time, the expenses of defending that other longshoreman’s lawsuit would have to be paid by the stevedore; and if another longshoreman

had asked Lockett to step backward, with the result that Lockett fell as he did so, the stevedore likewise would have to pay the expenses of defending Lockett's suit in the present case.

Under the authorities such a suit as this could be settled by the shipowner with the longshoreman, for a reasonable figure, and the settlement money as well as expenses could clearly be recovered over from the stevedore, as in *Damanti v. A/S Inger*, 314 F.2d 395, 1963 A.M.C. 852 (2d Cir.). It is scarcely in the interest of stevedores to promote such a settlement in lieu of a completely effective defense. It seems anomalous, indeed, that indemnity should be denied in the single situation in which the most complete and effective defense is made by the shipowner.

### C. Policy Considerations

The Supreme Court has stated the policy in this class of case to be "that liability should fall upon the party best situated to adopt preventive measures and thereby to reduce the likelihood of injury." *Italia Societa per Azioni di Navigazione v. Oregon Stevedoring Company*, 376 U.S. 315, 324, 1964 A.M.C. 1075, 1082. It is the stevedore which is best situated to encourage safety on the part of longshoremen when they injure themselves, as well as when they injure others, and the decision of the Court below was therefore contrary to the established policy.

As the Courts of other Circuits have pointed out, in cases which we have already quoted, the rule announced by the Court below would put a premium on losing lawsuits and discourage the shipowner from incurring the

expense to make the best defense available to the longshoreman's claim. It can scarcely be the policy of the law to make a lackadaisical or sham defense profitable where liability does not exist and to turn a lawsuit into a partially fictional proceeding in which the actual interest of one of the parties is contrary to the role it plays in court.

As for the policy argument of the Court below that the allowance of indemnity might result in discouraging the bringing of such suits as this, that argument was set forth with great fervor in the dissent in *Ryan Stevedoring Company v. Pan-Atlantic Steamship Corporation*, 350 U.S. 124, 144, 1956 A.M.C. 9, 25, and rejected by the Court. On the basis of the rule announced by the Court in the *Ryan* case, the *Ryan* dissenters foretold the end of longshoremen's third party suits against vessels. This Court can evaluate that prediction in the light of its own experience. While the threat of indemnity may be allowed to exert whatever discouraging influence it has upon meritorious claims of every sort, the policy now announced by the Court below in the present case is that unmeritorious claims, and unmeritorious claims alone, are not to be so discouraged. The proposition that sound legal policy does not encourage the filing of unmeritorious claims requires, we trust, no citation nor argument.



**CONCLUSION**

For the foregoing reasons we submit that the Judgment of the District Court should be reversed with directions to enter a judgment in favor of Appellant for the amount of its expenses in the successful defense of the Libelant's case.

Dated, San Francisco, California,  
September 22, 1966.

Respectfully submitted,  
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---

**CERTIFICATE OF COUNSEL**

I certify that, in connection with the preparation of this brief, I have examined Rules 18 and 19 of the United States Court of Appeals for the Ninth Circuit, and that, in my opinion, the foregoing brief is in full compliance with those rules.

GRAYDON S. STARING,  
*Of Attorneys for Appellant.*



No. 20,872

IN THE

United States Court of Appeals  
For the Ninth Circuit

ARISTA CIA. DE VAPORES, S.A.,

*Appellant,*

VS.

HOWARD TERMINAL,

*Appellee.*

BRIEF FOR APPELLEE

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No. 20,872

IN THE

**United States Court of Appeals  
For the Ninth Circuit**

---

ARISTA CIA. DEVAPORES, S.A.,

*Appellant,*

VS.

HOWARD TERMINAL,

*Appellee.*

---

**BRIEF FOR APPELLEE**

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**JURISDICTION**

Appellee concurs in Appellant's statement concerning jurisdiction.

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**ARGUMENT**

- I. IN EACH OF THE CASES CITED BY THE STEVEDORE IN SUPPORT OF ITS POSITION EITHER THE NEGLIGENCE RENDERED THE VESSEL UNSEAWORTHY OR THE LONG-SHOREMAN'S INJURY WAS NOT SOLELY THE RESULT OF HIS OWN NEGLIGENCE.

The shipowner here contends that the stevedore had breached its warranty of workmanlike service where there was no liability on the part of the vessel and where the sole proximate cause of the longshoreman's injury was

his own negligence. However, in each of the cases cited by the shipowner in support of this proposition the injured longshoreman's negligence rendered the vessel unseaworthy or the longshoreman's injury was not solely the result of his own negligence.

In *Damanti v. A/S Inger*, 314 F.2d 395 (2d Cir. 1963), the court stated at page 398 that "on the liability of the shipowner there was evidence that the beam jack was defective in that it was rusted, pitted, bent and with its beam holding teeth imperfect, that these defects caused it to slip off the beam and cause plaintiff and the jack to fall into the hold."

In *Guarracino v. Luckenbach*, 333 F.2d 646 (2d Cir. 1964), the court stated at page 648 that the stevedore's warranty of workmanlike service was breached in two respects which were "the abandonment of his post by the hatch boss in the face of his general instructions to stay at the hatch until a ladder was brought, and the action of libelant, when a safe alternative was available, in taking a way out likely to cause injury to himself and his fellow worker."

In *American Export Lines v. Norfolk Shipbuilding & Drydock Corp.*, 336 F.2d 525 (4th Cir. 1964), the court's decision only indicates that the shipyard "alone was responsible for its negligence" and does not indicate whether or not the libelant was himself negligent. The court does state at page 527 that "conceivably, a plaintiff's claim may be so far fetched and palpably devoid of substance as to furnish no basis for invoking an obligation of indemnity".

In *Massa v. C. A. Venezuelan Navigacion*, 332 F.2d 779 (2d Cir. 1964), “the plaintiff was injured when some of the cargo spilled from a pallet that had been raised about eight feet by the ship’s winch” and the appellate court did not disturb the trial court’s finding “that the accident was caused by the plaintiff and his fellow longshoremen”. *Id.* at 781.

In *Strachan Shipping Co. v. Koninklyke, etc.*, 324 F.2d 746 (5th Cir. 1963), “the proximate cause of the injury was the stevedore’s failure to perform its duties in a safe and workmanlike manner because it made improper use of the ship’s loading facilities”. *Id.* at 746. There is no suggestion in this case that the plaintiff longshoreman was injured solely because of his own negligence. This case was known as *Caswell v. K.N.S.M.*, 205 F.Supp. 295 (S.D. Tex. 1962) in the court below.

In *A/B Dalen v. Maher*, 303 F.2d 565 (4th Cir. 1962), it is apparent that the longshoreman was injured as a result of unseaworthiness on the part of the vessel attributable solely to the improper stowage of coal by the stevedore.

In *Nicroli v. Den Norske Afrika, etc.*, 332 F.2d 651 (2d Cir. 1964), cited by appellant for the first time in its brief on appeal, the longshoreman was injured partly as a result of a dangerous condition on the vessel and partly as a result of his own negligence (which was assessed as being 50%).

In *Holley v. The Manfred Stansfield*, 186 F.Supp. 212 (E.D. Va. 1960), the negligence of the injured longshoreman caused the vessel to become unseaworthy.



II. NEGLIGENCE ON THE PART OF A LONGSHOREMAN (THE SERVANT) CAUSING INJURY ONLY TO HIMSELF IS NOT A TORT AS IT IS NOT A BREACH OF A LEGAL DUTY OWED TO ANOTHER; ACCORDINGLY SUCH NEGLIGENCE ALONE WILL NOT IMPUTE NEGLIGENCE TO THE STEVEDORE (THE MASTER) TO THE END OF MAKING THE STEVEDORE LIABLE TO AN INDEMNITEE (HERE, THE SHIP-OWNER).

We know of only one decision which has squarely decided the issue at bar on facts raising that issue. In *Drewery v. Daspit Bros. Marine Divers, Inc.*, 317 F.2d 425 (5th Cir. 1963), the plaintiff was employed by Daspit Bros. Marine Divers who had contracted to render maritime services to Shell Oil Co. Shell and Daspit had entered into a contract of indemnity whereunder Daspit undertook to indemnify Shell from all claims except where the claim resulted without negligence or fault on the part of Daspit. In the court of appeals it was "undisputed . . . that Daspit was not negligent otherwise than through [the plaintiff]." *Id.* at 427. In ruling on Shell's action for indemnification, the court reviewed the status of the doctrine of imputed negligence and stated:

These authorities make it clear that imputed negligence, based as it is on a fiction, works to hold the master for injuries to third persons occasioned by the fault of his servant, and to bar the master where his servant contributes or concurs in the harm done the master. We are asked to take the doctrine one step further; to embrace the master through the imputation to the master of the negligence of the servant resulting in injury to himself, to the end of creating liability on the part of the master to an indemnitee under the terms of a contract.

But this additional step does not follow for here no tort against either a third person or the master is

present, and the legal fiction of imputed negligence rests on such a tort. Negligence causing injury to one's self will not suffice, for a tort rests on the breach of a legal duty owed another. To take this step would be adding a legal fiction to another legal fiction.

. . .

Thus it is that the master cannot be held unless the court is to extend the doctrine of imputed negligence to a new area, and to a point it has never reached. This we decline to do. *Id.* at 428.

We submit that the *Drewery* rationale is correct notwithstanding language in *Damanti* to the contrary. To hold otherwise would be to extend, for the first time, the indemnification covered by the stevedore's implied warranty of workmanlike performance to situations where the stevedore's performance neither gave rise to liability on the part of the shipowner nor was faulty in any respect except through the negligence of the injured longshoreman. We further submit that this is an area which is better suited to express contractual agreement rather than extension of an existing implied warranty.

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**III. THIS CASE IS INDISTINGUISHABLE FROM ONE WHERE THE LONGSHOREMAN'S SUIT IS COMPLETELY GROUNDLESS, SUCH AS WHERE THERE WAS NO INJURY, AND IN SUCH A CASE THERE IS NO BREACH OF WARRANTY BY THE STEVEDORE.**

If a longshoreman were to bring suit without there in fact having been an injury, there would be no breach of warranty by the stevedore and the shipowner of course

could not recover its costs of defense. As was stated by District Court in its Memorandum Opinion,

“The Shipowner (like all other property owners) must accept the burden of defending himself against unmeritorious claims of workmen invited on his premises and cannot look to the Stevedore for reimbursement.”

---

### CONCLUSION

For the foregoing reasons we submit that the Judgment of the District Court should be upheld.

Dated, San Francisco, California,  
October 10, 1966.

Respectfully submitted,

GRAHAM JAMES & ROLPH

WALTER M. SCHEY

*Attorneys for Appellee*

---

### CERTIFICATE OF COUNSEL

I certify that, in connection with the preparation of this brief, I have examined Rules 18 and 19 of the United States Court of Appeals for the Ninth Circuit, and that, in my opinion, the foregoing brief is in full compliance with those rules.

WALTER M. SCHEY

*Of Attorneys for Appellee*



No. 20,872

IN THE

United States Court of Appeals  
For the Ninth Circuit

ARISTA CIA. DE VAPORES, S.A.,

*Appellant,*

vs.

HOWARD TERMINAL,

*Appellee.*

APPELLANT'S REPLY BRIEF

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No. 20,872

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---

**APPELLANT'S REPLY BRIEF**

---

**ARGUMENT**

In its brief, Appellee reviews a number of cases as having been cited by Appellant for the proposition "that the stevedore had breached its warranty of workmanlike service where there was no liability on the part of the vessel and where the sole proximate cause of the long-shoreman's injury was his own negligence." A reference to Appellant's brief shows that, of the eight cases referred to by Appellee, only three, *Damanti*<sup>1</sup>, *Guarracino*<sup>2</sup> and *Massa*<sup>3</sup>, were cited by us for the entire proposition

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<sup>1</sup>*Damanti v. A/S Inger*, 314 F.2d 395, 1963 A.M.C. 852 (2d Cir.).

<sup>2</sup>*Guarracino v. Luckenbach Steamship Company*, 333 F.2d 646, 1964 A.M.C. 2240 (2d Cir.).

<sup>3</sup>*Massa v. C. A. Venezuelan Navigacion*, 332 F.2d 779, 1964 A.M.C. 1375 (2d Cir.).

quoted above. The remainder of the cases reviewed by Appellee were cited for narrower propositions such as the proposition that the injured man's negligence could be the sole basis of indemnity where the vessel had been held liable for unseaworthiness. We believe that a review of Appellant's brief will show that every case cited by Appellant supports the proposition for which it is cited.

The *Damanti*, *Guarracino* and *Massa* cases are all good authority for the proposition that indemnity is due for the expenses of a successful defense where the injury was caused solely by the negligence of the injured man.

Appellee disparages *Damanti* by quoting language from the opinion indicating that there was evidence of possible unseaworthiness. The *Damanti* case concerned only the indemnity claim (the injured man's claim having been settled) and the trier of fact found that there was no unseaworthiness of the vessel nor negligence of her owner and that the injury was caused solely by stevedore negligence, evidently in respect of the actions of the injured longshoreman alone. The reference of the Court of Appeals to evidence of unseaworthiness was not a finding to that effect but concerned only the reasonableness of the conduct of the shipowner in settling the injured longshoreman's claim. *Damanti* stands unqualifiedly for the shipowner's position in the present case.

In *Guarracino* and *Massa* two grounds existed for indemnity, the negligence of the injured man himself and the concurrent negligence of a co-employee. The Court, in each case, gave these bases of stevedore liability equal dignity and made it explicitly clear that the negligence of



the injured man himself was adequate to impose indemnity.

The stevedore makes an argument that it should not be held because the longshoreman's negligence in causing injury to himself is not a tort. It is difficult to understand this, as liability is not sought to be imposed on a tort basis but rather upon the conventional contract basis that the stevedore has not performed safely and properly and in a workmanlike manner. Whether negligence that injures only the negligent person is a tort does not seem like a fruitful inquiry. What does seem clear is that negligence is not safe, proper and workmanlike performance, whether it injures the negligent man, another man or both simultaneously.

Appellee asserts that the *Drewery* case<sup>4</sup> "has squarely decided the issue at bar". The *Drewery* case was difficult to follow, since the Court's decision appeared to be based upon some hesitancy in embracing the truism that the doctrine of *respondeat superior* applies not only to vessel owners but to stevedores or other maritime contractors in the performance of their contracts. However that may be, the *Drewery* court, in *Lusich v. Bloomfield Steamship Company*, 355 F.2d 770, 1966 A.M.C. 191 (5th Cir.), has restricted *Drewery* to the contract involved in the particular case and rejected its application to cases like the present one.

The stevedore argues against indemnity by analogy to a hypothetical claim which could be successfully defended

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<sup>4</sup>*Drewery v. Daspit Bros. Marine Divers, Inc.*, 317 F.2d 425, 1963 A.M.C. 1787 (5th Cir.).

on different grounds than here. There are a number of bases on which claims may be successfully defended besides establishing that the vessel was not unseaworthy. For example, a suit by a longshoreman on account of injuries caused by stevedore carelessness, whether or not a condition of unseaworthiness is created in the process, may be dismissed after lengthy proceedings because it is barred by the statute of limitations or by failure to prosecute. Surely the stevedore should not escape liability for the shipowner's expenses simply because the shipowner has been able to defeat liability on a technical ground of that sort. To be sure, if the longshoreman's claim is defeated because there has simply been no negligence or other breach of duty on the part of anyone, the stevedore is not liable. But this is not such a case, any more than it is a case of no injury at all. This is in fact a case in which the stevedore's performance was not safe and proper and an injury occurred as a result. Indemnity should not depend upon the fortuitous technicality that the stevedore's negligence, in the process of injury, creates a condition which may be found to constitute unseaworthiness.

Dated, San Francisco, California,  
November 1, 1966.

LILLICK, GEARY, WHEAT, ADAMS & CHARLES,  
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---

# United States Court of Appeals

NINTH CIRCUIT

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MICHELE MARCHESE,

Petitioner-Appellant,

vs.

UNITED STATES OF AMERICA, et al.,

Respondents-Appellees.

---

JESSE DEL BONO,

Petitioner-Appellant,

vs.

UNITED STATES OF AMERICA, et al.,

Respondents-Appellees.

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APPELLANTS' OPENING BRIEF

---

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No. 20893

IN THE  
UNITED STATES COURT OF APPEALS  
FOR THE NINTH CIRCUIT

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MICHELE MARCHESE,

Petitioner-Appellant,

vs.

UNITED STATES OF AMERICA, et al.,

Respondents-Appellees.

---

JESSE DEL BONO,

Petitioner-Appellant,

vs.

UNITED STATES OF AMERICA, et al.,

Respondents-Appellees.

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APPELLANTS' OPENING BRIEF

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## STATEMENT OF THE CASE

Appellants were convicted, following jury trial on June 16, 1958, for violation of Title 18, Section 371 and Title 21 of Section 174, United States Code, relating to conspiracy and sale of heroin. On their joint appeal (Case No. 16151) this Court affirmed the judgments of conviction, on April 15, 1959 (264 F. 2nd 892). On June 29, 1959, certiorari was denied by the Supreme Court (360 U.S. 930, 938).

On November 16, 1960, in Case No. 1300-60-T.C. Marchese filed a motion to annul, vacate and set aside his judgment of conviction, under Title 28, Section 2255 U.S.C. Del Bono filed a similar motion on December 9, 1960, in Case No. 1379-60 T.C. Both motions were denied by the Honorable Thurmond Clarke, the same judge who presided at their trial. On February 3, 1961, both appellants filed motions for reconsideration of the orders denying their motions. On March 14, 1961, Del Bono's motion was denied and on March 15, 1961, Marchese's motion was denied.

Inadvertently, both appellees permitted the time for appeal to expire.



On June 20, 1961, Marchese, who was then incarcerated at the Federal Correctional Institution at Terminal Island, filed a petition for writ of habeas corpus in Case No. 801-61-T.C. (Clerk's Transcript pp. 2-47). Appellees filed a return to this petition on June 29, 1961, and on the same day the Honorable Pierson Hall, in the absence of Judge Clarke, denied and dismissed the petition *ex parte* without a hearing. Marchese filed notice of appeal, and in Case No. 17480, this Court, on May 31, 1962, affirmed said order of dismissal (304 F. 2nd 154<sup>[1]</sup>).

In the meantime, on December 19, 1961, Del Bono, in Case No. 1595-61 T.C. filed a new motion for relief under Title 28 Section 2255 U.S.C., which motion was denied by Judge Clarke on December 27, 1961. Del Bono did not appeal

[1] The Circuit Court held:

(a) "Petitioner having failed to appeal from the denial of his motion under Section 2255 may not now question either the ruling on that motion, or the validity of his sentence, by use of habeas corpus."

(b) "Petitioner fares no better if his application for writ of habeas corpus is treated as a second motion under Section 2255." The Court held, in effect, that the new grounds urged were based upon decisions of the Supreme Court subsequent to the original motion and that such could not be done. The Court cited *Hill v. United States*, 368 U.S. 424, which quoted from *Sunal v. Large*, 332 U.S. 174, but overlooked one exception set forth in *Sunal*, namely, "where the error does not trench on any constitutional rights of defendants."

(c) "Even if these may be considered new grounds,





Following the aforesaid decision of this Court on May 31, 1962, Marchese filed a petition for certiorari in the Supreme Court. On June 10, 1963, the Supreme Court reversed this Court and the District Court, granted certiorari and remanded the case (374 U.S. 101). Its decision read as follows:

*"Per Curiam.*

"The petition for writ of certiorari is granted, the judgment vacated and the case remanded to the United States District Court for the Southern District of California for reconsideration in the light of *Sanders v. United States*, 373 U.S. 1." (C.T. p. 63)

Following such reversal and remand, Judge Clarke heard the petition of Marchese for habeas corpus in several sessions terminating on September 30, 1963, at which time he granted the petition. During the proceedings, on July 26, 1963, Marchese filed a Supplemental Memorandum in Support of Petition (C.T. 64-72) and also a Reply to the Supplement filed by respondents to Return to Petition for Writ of Habeas Corpus

[1 continued] the application fails to set forth the reason why petitioner was previously unable to assert the new grounds, and does not allege that he had previously been unaware of the significance of the relevant facts which is a standard established for consideration of successive motions under 2255. *Sanders v. United States*, 297 F. 2d 735 (9th Cir. 1961)."

It is to be noted that the *Sanders* case upon which the Court relied was reversed by the Supreme Court. 373 U.S. 1



(C.T. 102-110) and Memorandum in Support of Proposed Findings of Fact and Conclusions of Law (C.T. 114-117). On September 30, 1963, Judge Clarke signed the findings, conclusions, and judgment, wherein he adjudged that the petitioner be immediately released from custody. Incidental to such release, and primarily to fortify his order of release, at the request of Russell E. Parsons, the then attorney for Marchese, Judge Clarke reduced the sentence of Marchese from ten years to five years (C.T. 129-130).

On November 12, 1963, Del Bono filed a "Petition to Annul, Vacate and Set Aside or Modify the Judgment of Conviction . . . Pursuant to the Provisions of Title 28, United States Code, Sections 2255 and 2242" (C.T. 211-227). On December 20, 1963, after a hearing, Judge Clarke granted the petition and signed Findings of Fact and Conclusions of Law (C.T. 238-245) and a Judgment based thereon in favor of Del Bono (C.T. 246-247).

On November 27, 1963, fifty-eight days after the judgment was rendered in favor of Marchese, the Government filed a Notice of Appeal, and on February 17, 1964, filed a Notice of Appeal from the judgment in favor of Del Bono.

On February 10, 1965, this Court reversed the judgments





of the District Court (341 F. 2nd 782). Petition for certiorari was denied by the Supreme Court.

Following remand, on November 10, 1965, Marchese filed a "Motion to File Amended Findings of Fact, Conclusions of Law and Judgment, or in the Alternative to Treat Motion as New Supplemental Motion Under Sections 2243 and 2255, Title 28, U.S.C." (C.T. 143-149) and accompanied said motion by filing proposed Amended Findings and Conclusions of Law (C.T. 166-177) and proposed Amended Judgment (C.T. 179-181). On the same day, Del Bono filed a similar motion (C.T. 253-257) and proposed Amended Findings of Fact and Conclusions of Law (C.T. 258-268) and Amended Judgment (C.T. 269-271).

Said motions were argued before Judge Thurmond Clarke in several sessions of hearing.

The argument by Bruce I. Hochman, one of Marchese's attorneys and by Russell E. Parsons, to which reference is made is set forth in Reporter's Transcript of said hearing (65-RT 5-18, 22-24<sup>[2]</sup>). Judge Clarke, being of the same opinion as attorneys for appellants - that the decision of this Court was "somewhat

[2] When reference is made to the Reporter's Transcript of the trial, the symbol will be "Trial R.T."; reference to the Reporter's Transcript of the hearing in July, August and September of 1963, will be "63-R.T."; reference to the Reporter's Transcript of the last hearing will be "65-R.T."; reference to the Clerk's Transcript is "C.T."



ambiguous" - nevertheless denied the motions and certified the matter to this Court in order to ascertain what powers he had under this Court's last decision (65-R.T. 30, 32, 37, 38, 45-47). Apparently no minute order was made, and since it was discovered later, following the filing of Notices of Appeal, an order was signed by Judge Clarke on April 27, 1966, *nunc pro tunc* as of January 20, 1966, prior to the filing of Notices of Appeal (C.T. 207-209). Amended and Supplemental Notices of Appeal were filed on May 16, 1966, to protect the appeal (C.T. 279-281).

#### JURISDICTION

The jurisdiction of the District Court was invoked under Sections 2241, 2243, 2255 of Title 28, United States Code. This Court has jurisdiction on the joint appeal of Marchese and Del Bono to review the judgment of the District Court under Sections 1291, 1294, 2253, 2255 of the United States Code.





## STATUTES INVOLVED ON APPEAL

Title 28, Sections 2241, 2242, 2243, 2244, 2253, 2255  
of United States Code.

United States Constitution:

Article I, Section 9, Clause II

Fourth, Fifth and Sixth Amendments.

## STATUTES INVOLVED IN PETITIONS AND MOTIONS

Title 18, Sections 2, 371, and 1403(2) of United States  
Code.

Title 18, Sections 4161 et seq. of United States Code.

Title 21, Section 174 of United States Code.

Title 26, Section 7257 of United States Code.

Title 28, sections 2243 and 2255 of United States Code.

Fourth, Fifth and Sixth Amendments of United States  
Constitution.



## STATEMENT OF FACTS

The facts in connection with the alleged activities of appellants, the investigation by the Government, the arrests of appellants and the testimony at their trial have been set forth in detail in the petition of Marchese (C.T. 6-11) and in the petition of Del Bono (C.T. 214-219). This Court, in its opinion on the last appeal, also summarized certain facts in Notes 3 and 4. We shall, therefore, set forth here only the facts pertinent to the issues on the appeal and, briefly, also some pertinent facts in our Argument.

Sussman, a narcotics addict, was arrested by Federal narcotics agents on January 30, 1958, for the sale of heroin, and charged with violation of Section 174 of Title 21, U.S.C. At that time he was on five years probation for violation of California's narcotics laws. He was taken to the office of the Narcotics Bureau in Los Angeles and conferred with both Federal and State narcotics agents. He was then made a "special employee" and taken before United States Commissioner Hocke and released "O.R." at the instigation of Agent Richards who was in charge of the investigation. (Trial-R.T. 18, 19, 63; 63-R.T. 9-39). On January 30th, Sussman was equipped by the agents with a Schmidt electronic transmitting device concealed on his person and then sent to Marchese's apartment at





11032 Moorpark Avenue, North Hollywood, California.

Sussman had been a friend of Marchese's for many years. Marchese had assisted him and his family financially on many occasions and had even sent him to Mexico, paying all expenses, in order to cure him of his narcotics addiction. Because of his friendship, Sussman was admitted by Marchese into his apartment. The conversation between Sussman and Marchese was overheard by means of a receiving device by Agent Richards and Los Angeles County Deputy Sheriff Farrington, stationed a block or two away. (Trial-R.T. 20-33) This same procedure was followed on January 31, and February 7, 1958. (Trial-R.T. 43-45, 48-50; 63-R.T. 35-39). At all times Marchese knew nothing of the transmitter concealed upon Sussman's person and knew nothing about Richards' and Farrington's listening in on the conversations. (Trial-R.T. 441-445)

Sussman's testimony was in conflict with that of Richards as to what was said. Sussman also testified that the testimony was recorded and he signed a statement taken from the recording. (Trial-R.T. 425) When demand was made for the production of such recording, Richards denied that there was a recording. Farrington's testimony was also in conflict with that of Richards, and Farrington also testified that he could hear only about 75% of the conversation. (Trial-R.T. 515-516)



Despite the fact that the finger of the agents' investigation was pointed at Marchese and Del Bono at the aforesaid conference and in the surveillance that followed, and despite two alleged deliveries by Del Bono at a service station on January 31st and February 7th, 1958, no warrant of arrest or search warrant was obtained either against Marchese or Del Bono; yet, on March 13, 1958, both were arrested at a considerable distance from the location of the automobile wherein was found a quantity of heroin. The apartment of Marchese was searched also following the officers' forcible entry therein and his arrest.

ISSUES INVOLVED  
AND  
SPECIFICATIONS OF ERRORS

1. The use of evidence obtained by means of the electronic transmitting device (known as the Schmidt transmitter) was unlawful and violated the Fourth, Fifth and Sixth Amendments of the United States Constitution.

2. Appellants had the right to raise a substantial constitutional question, even though said question could have been or was litigated on previous proceedings, including the appeal from the judgment of conviction.





3. Any determination made by the court on a motion under Section 2255 of Title 28, U.S.C., or habeas corpus under Section 2243 of Title 28, U.S.C., is not *res judicata*, and the same question may be raised on subsequent petitions or motions under said sections, especially where constitutional rights have been invaded.

4. The United States District Court, following the opinion and remand by the Circuit Court on the last appeal, had the jurisdiction and power to file amended findings of fact and conclusions of law, and an amended judgment based thereon, granting to petitioners the relief sought by them and intended by the District Court, namely, their full and complete discharge.

5. Since the opinion and remand by the Circuit Court aforesaid was ambiguous, the District Court should have resolved the ambiguity in favor of the petitioners and should have granted them the relief of a complete discharge instead of certifying the cases back to the Circuit Court for clarification as to the District Court's power and jurisdiction to determine the matter.

6. Since *res judicata* does not apply to motions under Section 2255 or habeas corpus, the District Court should have



treated the motions made by the petitioners in the alternative as new motions under Sections 2255 and 2243 of Title 28, U.S.C., and granted petitioners full and complete discharge as apparently authorized or permitted by the opinion of the Circuit Court.

7. If the District Court had treated said motions in the alternative as new motions aforesaid, it had the power and jurisdiction to make new findings of fact and conclusions of law and judgment, based upon matters presented at all of the hearings and upon the record of the case, especially with respect to the violation of the petitioners' constitutional rights in connection with the use by the Government of the Schmidt Transmitter.

8. That the findings of the District Court originally made were not clearly erroneous, and that this Court should review and revise its decision with respect to the findings made by the trial court, in the light of long established fundamental principles governing appellate powers and procedure with respect to findings of fact.





## ARGUMENT

### I

THE USE OF EVIDENCE OBTAINED BY MEANS OF THE ELECTRONIC TRANSMITTING DEVICE (KNOWN AS THE SCHMIDT TRANSMITTER) WAS UNLAWFUL AND VIOLATED THE FOURTH, FIFTH AND SIXTH AMENDMENTS OF THE UNITED STATES CONSTITUTION.

The evidence obtained by the use of the Schmidt transmitter was very important to the Government's case and was most prejudicial to appellants. The court, at the trial, admitted such evidence over objection by appellants. At that time the case of *On Lee v. United States*, 343 U.S. 747, a five to four decision, was controlling and it was also controlling when this Court sustained the judgment of conviction, without opinion, in 1959 (264 F. 2nd 892).

*On Lee* may be distinguished from the instant case in that here the transmission took place in Marchese's private apartment, whereas in *On Lee* the transmission took place in the public portion of On Lee's laundry, where the public was invited and his customers and the public were served, and also on the sidewalks of New York. In *On Lee* even the Solicitor General of the United States recognized the distinction, for he stated in his opening brief, page 29, with reference to Judge Frank's dissenting opinion in the Circuit



Court as follows:

"The various situations envisaged in the dissenting opinion where mechanical contrivances are used to publish conversation within a private home are unrelated to the present case. As has been observed above, *a private home is not involved; the conversation took place in a place to which the public was invited.*" (Emphasis added.)

Based on this distinction alone, we submit that the use of the hidden transmitter was a violation of Marchese's rights under the Fourth Amendment. Being thus tainted, it could not be used against Del Bono either as to the substantive counts or the conspiracy counts.

However, the *On Lee* case is no longer authority or controlling. The first breach in the *On Lee* decision was made in the case of *Silverman v. United States*, 365 U.S. 505, wherein a "spike mike" was driven into the outer wall of Silverman's apartment, by which, with the use of an electronic device, agents outside the apartment listened in on conversations taking place in the apartment. This was held to be a violation of Silverman's constitutional rights under the Fourth Amendment and the evidence was held inadmissible. In its decision, referring to the case of *Goldman v. United States*, 316 U.S. 129, where a "detectaphone" was used outside the walls of Goldman's apartment, the Court stated in its





concluding paragraph:

"We find no occasion to re-examine *Goldman* here, but we decline to go beyond it, even by a fraction of an inch."

It was very significant that no such statement was made with respect to the *On Lee* case. In fact, in Note 4 of its opinion, the Court quoted with approval a portion of Judge Jerome Frank's dissenting opinion in the Circuit Court in the *On Lee* case, as to the right of privacy under the Fourth Amendment, as follows:

"William Pitt's eloquent description of this right has been often quoted. The late Judge Jerome Frank made the point in more contemporary language, 'A man can still control a small part of his environment, his house; he can retreat thence from outsiders, secure in the knowledge that they cannot get at him without disobeying the Constitution. There is still a sizeable bank of liberty - worth protecting from encroachment. A sane, decent, civilized society must provide some such oasis, some shelter from public scrutiny, some insulated enclosure, some enclave, some inviolate place which is a man's castle.' (*United States v. On Lee*, 193 Fed. 2nd 306, 315, 316 [dissenting opinion].)"

The latest expression of the Supreme Court on this point is the case of *Lopez v. United States*, 373 U.S. 426 (May 27, 1963), wherein the Supreme Court indicated *On Lee* was no longer authority. The hidden transmitter failed to work, so



the use thereof was not directly an issue in the case<sup>[3]</sup>.

The opinion of various justices clearly showed that they, as well as the other members of the Court, regarded that the evidence obtained by use of a hidden transmitter was no longer permissible under the Fourth and Fifth Amendments.

Mr. Justice Warren, in concurring with the majority opinion, stated:

"Since I agree with Mr. Justice Brennan that the *On Lee* case was wrongly decided and should not be revitalized, but base my views on grounds different from those stated in the dissent, I have chosen to concur specially. I also share the opinion of Mr. Justice Brennan that the fantastic advances in the field of electronic communication constitute a grave danger to the privacy of the individual; that indiscriminate use of such devices in law enforcement raises grave constitutional questions under the Fourth and Fifth Amendments."

Mr. Justice Warren also distinguished the *On Lee* case from the *Lopez* case, in that in the former the one on whose

[3] In the *Lopez* case, a treasury agent called several times upon defendant, investigating the latter's income tax returns. The defendant offered him bribes and, on the last occasion, the agent had concealed on him a recording device and electronic transmitter. The recording device worked but the transmitter did not. The majority felt there was a distinction between the use of a recording device and a transmitter, and permitted the tape recorded conversation to be used to corroborate the agent's testimony. The defendant also knew that the agent was a treasury agent and, knowing such, invited him to his home.





person the device was concealed was an informer and not known to *On Lee* as a special government agent, whereas in the *Lopez* case the defendant knew he was dealing with a revenue agent of the government.

Mr. Justice Harlan, in his dissenting opinion, joined by Mr. Justice Douglas and Mr. Justice Goldberg, stated with respect to *On Lee* as follows:

"I believe that the decision was error, in reason and authority, at the time it was decided; that subsequent experience has sapped whatever vitality it may once have had; that it should now be regarded as overruled; that the instant case is rationally indistinguishable; and that, therefore, we should reverse the judgment below.

"The United States, in its brief and oral argument before this Court in the instant case, made little effort to justify the result in *On Lee*, doubtless because it realized that that decision has lost virtually all of its force as authority. Instead, the government seeks to distinguish the instant case. This strategy has succeeded, it appears, with a majority of my Brethren. The Court's refusal to accord more than a passing mention in its opinion to the only decision of this Court - *On Lee* - factually analogous to the case at bar suggests very strongly that some of my colleagues who have joined the Court's opinion today agree with us that *On Lee* should be considered a dead letter."

The *Lopez* case was decided just two weeks before the Supreme Court granted certiorari and reversed this Court in the *Marchese* case, so it is reasonable to assume that



there was a violation of Marchese's constitutional rights by the use of the transmitter.

In the case of *Massiah v. United States*, 374 U.S. 805, a transmitter was hidden in the automobile of the co-defendant of Massiah, and the conversation was listened to by agents through the use of a receiving device. The Supreme Court, following the rule laid down in *Escobedo v. Illinois*, 375 U.S. 902, held that this was a violation of Massiah's constitutional rights under the Sixth Amendment. In view of such holding, the Court stated it was not necessary to pass upon the question whether the use of the transmitter was a violation of Massiah's rights under the Fourth Amendment, which is one of the issues in the instant case; nevertheless, we submit that the *Massiah* and *Escobedo* cases also apply to Marchese. The matter had already passed the investigatory stage and was in the accusatory stage when Sussman was equipped with the transmitting device, and the conversations thus transmitted were clearly a violation of Marchese's constitutional rights, and hence inadmissible under the rules of said cases either against him (Marchese) or his co-defendant Del Bono.

Prior to the filing by Marchese of his successful





petition for certiorari in the Supreme Court wherein it granted certiorari and reversed the case, this Court decided the case of *Todisco v. United States*, 298 F. 2nd 208. In said case, an Internal Revenue agent, after several attempts had been made by defendant to bribe him, was equipped with a transmitting device concealed on his person and conversations between him and the defendant in the latter's office were transmitted and recorded at the point of reception. The tapes were admitted in evidence over objection, to corroborate the agent's testimony. The Court held that there was no violation of the defendant's constitutional rights.

Since that date the *Lopez* case, *supra*, has been decided which distinctly indicates that such a procedure would constitute a violation of the defendant's rights under the Fourth and Fifth Amendments. There has also since been decided the *Massiah* case, *supra*, which supports the contention of appellants that Marchese's constitutional rights under the Sixth Amendment have been invaded. It is highly significant that in the last decision, this Court completely by-passed and evaded these issues and based its decision upon the erroneous ground that Section 2255 cannot take the place of an original appeal or be invoked to relitigate questions which were or should have been raised on direct appeal from the judgment of conviction. (798) We



shall point out the fallacy of such holding in our next point. Apparently this Court agreed with various justices of the Supreme Court expressed in the *Lopez* case, that the *On Lee* case was no longer authority and should be regarded as overruled. It is our understanding that the questions regarding the use of bugging devices and concealed transmitting devices are now before the Supreme Court awaiting its decision in several cases, including *Miller v. United States*, *Black v. United States*, and *Kolod v. United States*. (See also the argument of Bruce Hochman at the hearing [65-R.T. 10] as to other cases.)

Nevertheless, at the present time the controlling rule as expressed in the *Lopez* case is that the use of a transmitting device, as in the instant case, is an infringement and invasion of constitutional rights under the Fourth and Fifth Amendments.

This Court also by-passed the petitioners' contention No. 5 (p. 787) that the arrest of petitioner Marchese without a warrant, the search of Marchese's person and apartment and of the Del Bono automobile without a search warrant violated Marchese's constitutional rights under the Fourth Amendment, leaving this issue also open to the District Court.





The arrest of Marchese, the search of his person and his apartment violated his rights under the Fourth Amendment.

*Johnson v. United States*,  
333 U.S. 10;

*Taylor v. United States*,  
286 U.S. 1

*Chapman v. United States*  
5 L. Ed. 2d 828.

We submit that the violation of Marchese's constitutional rights by the use of evidence obtained by the Schmidt transmitter justified the discharge of Marchese and Del Bono by the District Court. It was unfortunate that Judge Clarke, at the insistence of counsel, in order to fortify his decision to grant the motion under 2255 or the petition for habeas corpus, reduced the sentence and discharged appellants for time served instead of granting absolute discharge "without the trimmings," namely, "for time served." Since his intent was to discharge appellants in any event, the other language should have been disregarded as surplusage and his true intent carried out, without a quibble on words.



## II

APPELLANTS HAD THE RIGHT TO RAISE A SUBSTANTIAL CONSTITUTIONAL QUESTION, EVEN THOUGH SAID QUESTION COULD HAVE BEEN OR WAS LITIGATED ON PREVIOUS PROCEEDINGS, INCLUDING THE APPEAL FROM THE JUDGMENT OF CONVICTION.

This Court, in its last opinion in the instant case, stated:

"Section 2255 cannot take the place of an original appeal. More properly stated, Section 2255 may not be invoked to re-litigate questions which were or should have been raised on a direct appeal from a judgment of conviction. *Dodd v. United States*, 321 F. 2d 249 (9th Cir. 1963); *Black v. United States*, 269 F. 2d 28 (9th Cir. 1959)."

By reason of its view above expressed, this Court bypassed the question as to the violation of constitutional rights of appellants arising out of the use of evidence obtained by means of the Schmidt transmitter and the invasion of constitutional rights under the Fourth Amendment through the arrest and search without either type of warrant.

We submit that this Court's ruling aforesaid was wholly erroneous, and is in direct conflict with numerous Supreme Court decisions, especially where constitutional rights are invaded or trespassed upon. In so ruling, this Court ignored and disregarded the opposition rule laid down in the following





cases:

*Salinger v. Loisel*,  
265 U.S. 224;

*Price v. Johnson*,  
334 U.S. 266;

*Waley v. Johnson*,  
316 U.S. 101;

*Sunal v. Large, supra*,  
332 U.S. 174;

*Foy v. Noia*,  
372 U.S. 301;

*Marchese v. United States, supra*,  
374 U.S. 101.

Clearly, the *Dodd* and *Black* cases decided by this Court have been overruled, have no persuasive effect, and cannot be relied upon as authority. This Court was reversed in both the *Sanders* and *Marchese* cases upon the rule it thus expressed.

As we have pointed out in Note 1 of this brief, *supra*, this Court, in its 1962 decision, held in effect that since *Marchese* failed to appeal from the denial of his motion, he could not question the ruling on that motion by use of habeas corpus or a new motion. This Court also held that points raised by *Marchese* based on subsequent decisions of the Supreme Court could not be considered under either a petition for habeas corpus or a new motion under Section 2255. The Supreme Court, in reversing said decision (374 U.S. 101),



effectively and completely overruled such holdings and views. Since the Supreme Court decision was controlling at the time of the 1965 decision, this Court was in error in persisting in following its own outmoded and discredited view, in conflict with the said Supreme Court decision, as well as with other Supreme Court decisions.

At most, the view of this Court is limited to errors at law occurring in the trial court. It is not applicable to cases where there has been an invasion of constitutional rights. Even the *Sunal* case and that of *Hill v. United States*, 368 U.S. 424, cited by the Court, clearly recognize the exception pertaining to the invasion of constitutional rights. In both of those cases, only errors at law were involved, and there was no invasion of constitutional rights. In the *Sunal* case, Justice Frankfurter, in his dissenting opinion, lists many cases setting forth exception to the rule expressed by this Court, in addition to the one involving constitutional rights.





### III

ANY DETERMINATION MADE BY THE COURT ON A MOTION UNDER SECTION 2255 OF TITLE 28, U.S.C., OR HABEAS CORPUS UNDER SECTION 2243 OF TITLE 28, U.S.C., IS NOT *RES JUDICATA*, AND THE SAME QUESTION MAY BE RAISED ON SUBSEQUENT PETITIONS OR MOTIONS UNDER SAID SECTIONS, ESPECIALLY WHERE CONSTITUTIONAL RIGHTS HAVE BEEN INVADED.

It has been repeatedly held that the doctrine of *res judicata* does not apply to habeas corpus or motions under Section 2255.

*Sanders v. United States, supra,*  
373 U.S. 1;

*Price v. Johnson, supra,*  
334 U.S. 266;

*Waley v. Johnson, supra,*  
316 U.S. 101;

*Hayman v. United States,*  
342 U.S. 205;

*Heflin v. United States,*  
358 U.S. 415.

In the *Sanders* case, the Supreme Court stated on page 8:

"Conventional notions of the finality of litigation have no place where life or liberty is at stake and infringement of constitutional rights is alleged. . . . The inapplicability of *res judicata* to habeas corpus, then, is inherent in the very role and function of the writ."

The Court further held that the remedy under the motion procedure of Section 2255 was "exactly commensurate with that which had



previously been available by habeas corpus in the district where the prisoner was confined," and that it was as broad as habeas corpus.

In the *Sanders* case there was no appeal from the judgment of conviction and no appeal from the denial of the first motion under 2255, yet the Supreme Court held that the failure to do so did not preclude defendant from making a second motion. With respect to successive motions under 2255 the Court stated on page 15:

"The judge is permitted, not compelled to decline to entertain such an application, and then only if he 'is satisfied that the ends of justice will not be served' by inquiring into its merits. . . .

"Controlling weight may be given to a denial of prior application for federal habeas corpus or section 2255 relied only if (1) the same ground presented in the subsequent application was determined adversely to applicant on prior application, (2) the prior determination was on the merits, and (3) the *ends of justice would not be served by reaching the merits of the subsequent application*.

"Even if the same ground was rejected on the merits on a prior application, it is open to the applicant to show that the ends of justice would be served by permitting the redetermination of the ground. Two further points should be noted. First, the foregoing enumeration is not intended to be exhaustive; *the test is 'ends of justice'* and it cannot be finely particularized." (Emphasis added.)





The denial of certiorari by the Supreme Court imports no expression of opinion on the merits of the case and carries no implication whatever regarding the Court's views on the merits of the case which it has declined to review.

*United States v. Carver,*  
261 U.S. 482;

*Maryland v. Baltimore,*  
338 U.S. 912.

We submit, however, that the granting of certiorari in the Marchese case indicates that the Supreme Court agreed with some, if not all of the grounds raised by Marchese in his petition, and that its decision effectively, completely and finally disposed of the Government's and this Court's contentions that appellants are precluded from raising questions of invasion of constitutional rights in the petition of Marchese for habeas corpus and Del Bono's petitions under Section 2255 or in the alternative habeas corpus under Section 2243, Title 28, U.S.C. In precluding and foreclosing such rights, this Court's decision was in conflict with the decision of the Supreme Court and erroneous.



#### IV

THE UNITED STATES DISTRICT COURT, FOLLOWING THE OPINION AND REMAND BY THE CIRCUIT COURT ON THE LAST APPEAL, HAD THE JURISDICTION AND POWER TO FILE AMENDED FINDINGS OF FACT AND CONCLUSIONS OF LAW, AND AN AMENDED JUDGMENT BASED THEREON, GRANTING TO PETITIONERS THE RELIEF SOUGHT BY THEM AND INTENDED BY THE DISTRICT COURT, NAMELY, THEIR FULL AND COMPLETE DISCHARGE.

The discussion between the defense and prosecution attorneys and Judge Clark clearly indicated that Judge Clarke intended to vacate the judgment and discharge Marchese and that he modified the sentence from ten years to five only to support his decision that Marchese be discharged<sup>[4]</sup>. Since such was his intent, this Court should not, by a technical view of the

[4] During the discussion, the following are some of the statements made by counsel and the court:

"THE COURT: Well, Mr. Parsons, I want to ask you a question. I am going to rule with you and I can rule, my thought is, on 2255. He has already been incarcerated for four and a half years . . ."(63-R.T. 74)

"MR. PARSONS: I think you can modify. I must respectfully disagree with Counsel for the Government. 2255 gives you full power. It says so in it. It followed the old English common law version of coram nobis and they merely put it in the statute - where there is a wrong, there is a remedy." (63-R.T. 74)

"THE COURT: Well, what will I do, I will dismiss the matter, using section 2255. I will order the defendant discharged at this time, his having served four years and how many months." (63-R.T. 76)





language used, prevent the carrying out of such intent. Such intent, after remand, can be expressed by the District Court, as required by the Circuit Court, in the filing of amended findings of fact and conclusions of law and an amended judgment vacating the judgment and granting the discharge.

The language of the Circuit Court, in its opinion, certainly authorizes, if it does not require, the District

[4 continued]

"MR. SCHULMAN [Assistant U.S. Attorney]: I do not understand the judgment, Your Honor . . .

"THE COURT: Well, I am dismissing it under 2255.

"MR. SCHULMAN: And you are granting the motion?

"THE COURT: That is right, and I am discharging the defendant now on the theory that he has already served four years and how many months, so many months."

(63-R.T. 77)

"THE COURT: I am doing it under 2255. Then in addition to that I am ordering him discharged, which Mr. Parsons requests, on the theory that he has already served."  
(63-R.T. 78)

"THE COURT: I said I am granting relief under section 2255. I am setting aside the sentence . . . I am going to vacate the sentence, but I am going to make it contingent on that and modify the sentence from 10 to 5 years. That is what Mr. Parsons advocates. He could be right and I could be wrong." (63-R.T. 127)

"THE COURT: Well, I am ordering both ways. I am ordering 2255 and then as another condition I am modifying the sentence from ten years to five years." (63-R.T. 127)



Court to make new and amended findings of fact and conclusions of law, to render an amended judgment based thereon, and afford relief to appellants within its jurisdiction, power and authority prescribed by this Court under Section 2255<sup>[5]</sup>. We particularly wish to emphasize the first two bases for reversal given by the Court on page 801, wherein the Court stated:

[5] The Circuit Court, in its opinion (341 F. 2nd 782), stated in part as follows:

Page 787: "We conclude that the district court order exceeded that court's authority and jurisdiction under 28 U.S.C. Section 2255 in two respects. A. Section 2255 authorizes the district court to do any one of four things: (1) 'vacate and set aside the judgment and discharge the prisoner,' or (2) 'resentence him, or (3) 'grant a new trial', or (4) 'correct the sentence.' None of the first three courses of action was adopted."

Page 788: "If the court's position is sound that error in fact occurred, of a kind that would justify granting of a Section 2255 motion, appellee's sentence should have been entirely vacated and set aside, and the prisoner discharged from any time based on illegal conviction.

"If the court vacates and sets aside the judgment of conviction, then, of course, the prisoner must be discharged or granted a new trial."

Page 794: "We must assume findings will be made on essential facts only, and not on those which are superfluous or immaterial. But we also require, and are entitled to the benefit of clear and explicit findings on any factual issue tried without a jury. 5 Moor 52.06 (3) (4) (5), 52.10

"Those before us are deficient in the respect theretofore pointed out.

"For that reason it is impossible for this court to determine the materiality of the following Findings of Fact, which are urged by petitioner below as error, but upon which no conclusions of law are based primarily:

"VII - With respect to Sussman's narcotic addiction.





"Having determined that the district court erred in one, exceeding its jurisdiction in granting unauthorized relief, two making insufficient findings to permit this court to ascertain upon what its conclusions were based . . ."

In accordance with the requirements of the opinion, appellants moved to file amended findings of fact and conclusions of law (C.T. 166-177, 258-268) and amended judgments (C.T. 179-181, 269-271) wherein the District Court

[5 continued]

"VIII - With respect to the use of the Schmidt radio receiver.

"IX - With respect to 'overheard telephone conversation.'

"It could be argued that we assume that it is for this reason (i.e., their immateriality) that no causal connection is stated or shown between Findings VII, VIII, and IX, and any Conclusions of Law. If there is no causal connection such Findings should not have been made, and if there was no reliance on such fact findings, explicit reference is likewise required between such findings and any conclusions resting thereon in order to enable this court to compare the conclusions and findings, and the facts found, with the evidence appearing in the record in our search for 'proper findings' to support the ruling."

Page 795: "We can only conclude the findings are not sufficiently clear to permit us to properly evaluate them, and if for no other reason than this, we would be required to reverse the judgment and remand for further findings and conclusions."

Page 801: Having determined that the district court erred in one exceeding its jurisdiction in granting unauthorized relief, two making insufficient findings to permit this court to ascertain upon what its conclusions were based . . . "



would grant the proper relief permitted or required by the opinion. Because of his uncertainty as to what could be done, Judge Clarke denied the motions without prejudice and certified the matter to this Court for clarification.

Where a judgment is reversed and the case remanded due in part to insufficiency of findings of fact and conclusions of law, the District Court must make new findings and conclusions if it can do so without a hearing, or if not it must have such further hearing as may be necessary to make proper findings and conclusions.

*Panama Mail S.S. Co. v. Vargas,*  
281 U.S. 70.

The Ninth Circuit Court has repeatedly held as it did in the instant case, that where the findings and conclusions are insufficient, the case must be reversed and remanded for further findings and conclusions.

*United States v. Trubow,*  
196 F. 2nd 161;

*Gillis v. Gillette,*  
177 F. 2nd 7;

*Medigovich v. Pac. Mutual Life*  
*Ins. Co.,* 235 F. 2nd 609.

In this case, the Circuit Court reversed the judgment because it was beyond the power and jurisdiction of the





District Court to grant the relief set forth in the judgment. The latter should be permitted to render the type of judgment that was within its power and jurisdiction and not be deprived or foreclosed of this right due to its error and misconception of the manner of relief it could grant.

In certain cases where there was a reversal of the judgment of conviction, the Government took a position the opposite of its position in the instant case. In the following cases the Government contended that a reversal of the judgment of conviction left the matter open for further proceedings, including a retrial, even though the remand was silent with respect thereto. The Circuit Court upheld the Government's contentions in the following cases.

*Kosak v. United States*,  
54 F. 2nd 72;

*Eubanks v. Louisiana*,  
356 U.S. 584;

*United States v. Reina*,  
172 Fed. Supp. 113;

*Hill v. Texas*,  
316 U.S. 400, 406.

In the instant case we submit that the reversal without an express mandate leaves all matters open except possibly the following:



1. The evidence was insufficient to support a finding that an improper agreement existed between the United States Attorney and the witness Sussman (based entirely on inference).

2. The evidence was insufficient to support a finding that the Assistant United States Attorney suppressed evidence.

3. That the District Court exceeded its authority in granting relief by way of reducing the sentence of petitioners.

The proposed amended findings of fact specifically cover these points.

First, the District Court declares it makes no finding on the issue and contentions of petitioners that Sussman was promised that he would receive a lighter sentence if he cooperated with government agents. (C.T. 169, 11. 9-13; 261, 11. 11-15)

Second, the District Court declares it makes no finding on the issue and contentions of petitioners that the United States Attorney abused the privilege of his office by suppressing and failing to disclose the truth,





and as to whether there was an improper agreement between the Assistant United States Attorney and Sussman. In other words, the District Court left the findings as to such matters to the Circuit Court as expressed in its opinion.

With respect to deficiencies in the findings and conclusions, as delineated by this Court, they are attempted to be corrected by the amended findings and conclusions.

As to No. 3, *supra*, the proposed amended judgment also corrects the asserted defects in the other judgment, by providing a vacation and setting aside of the judgment of conviction and ordering the discharge of petitioners. This is clearly within the power and jurisdiction of the District Court to do so.

## V

SINCE THE OPINION AND REMAND BY THE CIRCUIT COURT WAS AMBIGUOUS, THE DISTRICT COURT SHOULD HAVE RESOLVED THE AMBIGUITY IN FAVOR OF PETITIONERS AND SHOULD HAVE GRANTED THEM THE RELIEF OF COMPLETE DISCHARGE INSTEAD OF CERTIFYING THE CASES BACK TO THE CIRCUIT COURT FOR CLARIFICATION AS TO THE DISTRICT COURT'S POWER AND JURISDICTION TO DETERMINE THE MATTER.

We have discussed, *supra*, the violation and invasion of



appellants' constitutional rights under the Amendments to the Constitution. We have also discussed, *supra*, the power and jurisdiction of the District Court to make new findings and conclusions and to correct and amend its judgment to follow the limits under Section 2255 as prescribed by the Circuit Court. Since the mandate of reversal is silent as to future proceedings, it must be considered in connection with the opinion.

*Gulf Refining Co. v. United States*,  
269 U.S. 125;

*Bailey v. Henslee*, 309 F. 2d 840;

*Kosak v. United States*, *supra*,  
54 F. 2d 72;

*Fed. Home Loan Bank of San Francisco  
v. Hall*, 225 F. 2d 349 (9th Cir.)

It has been held that the Circuit Court has power to construe its mandate whenever it deems it advisable to do so.

*Kresge Co. v. Winget etc. Co.*,  
102 F. 2d 740;

*Meredith v. Fair*, 306 F. 2d 374.

However, Section 2243 of Title 28, U.S.C., gives the District Court the power "to hear and determine the facts, and dispose of the matter as law and justice require." Both Marchese's and Del Bono's petitions were filed under Section 2243 for habeas corpus and under the motion procedure under





Section 2255, which gives the District Court the power, if it believes there has been a denial or infringement of constitutional rights, so as to render the judgment vulnerable to collateral attack, to "vacate and set the judgment aside and (shall) discharge the prisoner . . . as may appear appropriate."

In its previous findings and conclusions, the trial court did conclude, even though not specifically, that petitioners' constitutional rights under the Fourth and Fifth Amendments had been denied them and so infringed upon as to amount to a denial of due process under the Amendments of the Constitution, and that it would be fair and equitable and just to modify, reduce, and correct the sentence to five years. In the proposed findings and conclusions there are specific findings and conclusions as to such infringement of constitutional rights, and that it would be fair and equitable and would serve the ends of justice to vacate and set aside the judgment of conviction and discharge petitioners.

Habeas corpus and motions under Section 2255 are governed by equitable principles.

*Sanders v. United States, supra,*  
373 U.S. 1;

*Foy v. Noia, supra,* 372 U.S. 301.



The petitions of appellants were filed under both Section 2243 for habeas corpus and under Section 2255 of Title 28, U.S.C. Under the former section, the District Court clearly had the power to do what law and justice might require under "equitable principles," without the restrictions placed thereon by the Circuit Court.

Since the District Court considered it fair, equitable and serving the ends of justice to grant the petitions in the first hearing, it should have resolved any ambiguity in the Circuit Court's opinion in favor of petitioners and granted the proper relief intended, under new and corrected findings and conclusions.

## VI

SINCE *RES JUDICATA* DOES NOT APPLY TO MOTIONS UNDER SECTION 2255 OR HABEAS CORPUS, THE DISTRICT COURT SHOULD HAVE TREATED THE MOTIONS MADE BY PETITIONERS IN THE ALTERNATIVE AS NEW MOTIONS UNDER SECTIONS 2255 AND 2243 OF TITLE 28, U.S.C., AND GRANTED PETITIONERS FULL AND COMPLETE DISCHARGE AS APPARENTLY AUTHORIZED OR PERMITTED BY THE OPINION OF THE CIRCUIT COURT.

The order *nunc pro tunc* provides as follows:

"In view of the above order certifying these matters to the Circuit Court for clarification, this Court makes no findings





or conclusions of the merits of the motions of petitioners as new or supplemental motions under Sections 2243 and 2255 Title 28 U.S.C. reserving the determination of such questions following further clarification of its decision, opinion and mandate by the Circuit Court." (C.T. 209)

We have pointed out, *supra*, under Point III, that the doctrine of *res judicata* does not apply to habeas corpus or motions under Section 2255, so we shall not reiterate the same. Because the doctrine of *res judicata* does not apply in this case, we submit that the District Court could and should have treated the motions of appellants in the alternative as new motions, since it was uncertain as to what it could do under the previous petitions by reason of the ambiguity in the Circuit Court opinion. If it had done so, the matter could then have been settled, so that there would be no need to remand the cases back to the District Court for further proceedings, unless, however, the Circuit Court changes its views in accordance with our contentions set forth, *infra*, in this brief and orders the petitioners completely discharged as was originally intended by the District Court.



## VII

IF THE DISTRICT COURT HAD TREATED SAID MOTIONS IN THE ALTERNATIVE AS NEW MOTIONS AFORESAID, IT HAD THE POWER AND JURISDICTION TO MAKE NEW FINDINGS OF FACT AND CONCLUSIONS OF LAW AND JUDGMENT, BASED UPON MATTERS PRESENTED AT ALL OF THE HEARINGS AND UPON THE RECORD OF THE CASE, ESPECIALLY WITH RESPECT TO THE VIOLATION OF THE PETITIONERS' CONSTITUTIONAL RIGHTS IN CONNECTION WITH THE USE BY THE GOVERNMENT OF THE SCHMIDT TRANSMITTER.

After a hearing on habeas corpus, either in granting or denying a writ, the trial court should make findings of fact and conclusions of law.

*United States etc. v. Chamberlin,*  
184 F. 2d 404; affirmed  
342 U.S. 845.

*Tucker v. Howard,* 177 F. 2d 494.

Section 2255 of Title 28, U.S.C., provides:

"Unless the motion and the files and records of the case conclusively show that the prisoner is entitled to no relief, the court shall cause notice thereof to be served upon the United States Attorney, grant a prompt hearing thereon, determine the issues and make findings of fact and conclusions of law with respect thereto."

In the instant case, notice was given to the United States Attorney and a hearing was had. Although the court reserved its ruling on the alternative motions, it nevertheless could and, we submit, it should have ruled thereon. It could then





have made findings of fact and conclusions of law upon the record of all hearings and trial, and made a determination similar to that made by it at the previous hearing in September and December of 1963. This is especially true for the reason that the Circuit Court failed to pass upon, in their entirety, the issues as to the infringement of appellants' constitutional rights under the Fourth, Fifth and Sixth Amendments by the use of the hidden transmitter and the arrest of Marchese and the search of his person and apartment without a warrant of arrest or search warrant. The Circuit Court thus left said issues open for further proceedings before the District Court, and the latter could have granted a complete discharge of appellants on those grounds alone, independently of any other ground, treating the motions as new or alternative motions.

#### VIII

THE FINDINGS OF THE DISTRICT COURT ORIGINALLY MADE WERE NOT CLEARLY ERRONEOUS, AND THIS COURT SHOULD REVIEW AND REVISE ITS DECISION WITH RESPECT TO THE FINDINGS MADE BY THE TRIAL COURT, IN THE LIGHT OF LONG ESTABLISHED FUNDAMENTAL PRINCIPLES GOVERNING APPELLATE POWERS AND PROCEDURE WITH RESPECT TO FINDINGS OF FACT.

Before discussing wherein this Court disregarded long



established principles of appellate review, we first wish to state that the Court, on this appeal, may review and revise the views expressed in its opinion and mandate.

In the case of *Perrone v. Pennsylvania RR. Co.*, 143 F. 2d 168, the court held that the "law of the case" was not binding on it and that it would be free to disregard it if, upon reconsideration, it felt its previous conclusions were substantially wrong.

In *Messenger v. Anderson*, 225 U.S. 436, Justice Holmes stated (page 444):

"In the absence of statute the phrase, law of the case, as applied to the effect of previous orders on the later action of the court rendering them in the same case, merely expresses the practice of courts generally not to reopen what has been decided, not a limit to their powers."

In the case of *General Life Insurance Co. v. Anderson*, 156 F. 2d 615, the court held that there was no doubt but that it had power upon second review to reach a result inconsistent with its first review of the same case. (Citing *Chesapeake & Ohio Ry. Co. v. McKell*, 209 F. 514, 516.)

In the case of *Commercial Bank of Shreveport v. Connolly*, 176 F. 2d 1004, at page 1006, the court stated:

"The doctrine of the law of the case





usually raises a disinclination on the part of an appellate court to reexamine its own prior legal pronouncements in a case, but the doctrine does not destroy its power to do so."

Accord: *Seagraves v. Wallace*, 69 F. 2d 163.

Having established that this Court may review and revise its previous decision, let us now proceed to show wherein its opinion should be revised and changed, due, we contend, to its disregard of long established principles of appellate review.

First: It ignored the intent of the trial judge to vacate and set aside the judgment and discharge appellants and, instead, places emphasis upon the judge's reduction of sentence and discharge for time served by appellants (merely as an adjunct to and for the purpose of fortifying his intended action and decision). All intendments are in favor of upholding the judgment of the trial court. (*Wick v. Keshner*, 244 F. 2d 146; *Ellison v. Frank*, 245 F. 2d 837 (9th Cir.).)

In the *Ellison* case the Ninth Circuit Court states (p. 839):

"As a trier of facts the credibility of witnesses and the weight given their testimony is a matter to be determined by the trial judge, and his findings must be sustained if supported by any substantial evidence."



Second: Even if the findings and conclusions are not complete, if they are sufficient to sustain the judgment the appellate court should affirm the judgment without remanding for more specific findings and conclusions. (*Alger v. United States*, 171 F. 2d 667; *Weber v. McKee*, 215 F. 2d 447.)

The trial court found specifically that the hidden transmitter was used, and concluded in the light of the *Lopez* case and the reversal of the *Marchese* case that the constitutional rights of the petitioners had been infringed. Whether there were other facts supporting the conclusion or not, the above was sufficient to support the judgment.

Third: The trial court and not the appellate court is charged with the duty of weighing the evidence, determining the credibility of the witnesses, determining inferences and making findings of fact. (*Kincade v. Mikles*, 144 F. 2d 784; *Flynn v. United States*, 205 F. 2d 756.)

Here, the trial court had before it the witnesses Agent Malcolm Richards and the prosecutor, the former Assistant United States Attorney, Bruce Bevan. The court could observe their demeanor and determine their credibility and make its decision based upon such determination.





Fourth: The trial court's findings cannot be set aside unless "clearly erroneous" and due regard must be given to the opportunity of the trial court to judge the credibility of the witnesses. (Title 28, U.S.C., Rule 52(a) of Rules of Civil Procedure; *Nishishawa v. Dulles*, 235 F. 2d 135 (9th Cir.).)

As counsel for Del Bono stated at the hearing:

"If I may say so, I am constantly before the appellate court, and they throw at me every day, 'Why, the jury determined this. Why, the trial court determined this. That is a question of fact. We are not triers of fact, we don't have the facilities.'" (65-R.T. 15)

This Court has consistently upheld findings of the trial court where there is evidence to support them.

*Engstrom v. Wiley*, 191 F. 2d 684, 686;

*Lerner Stores v. Lerner*, 161 F. 2d 160;

*Coast Metals, Inc. v. Hall*, 315 F. 2d 416;

*Puget Sound etc. Co. v. O'Reilly*,  
239 F. 2d 607.

In the *Puget Sound* case the Court, on page 609, stated:

"It must be borne in mind in connection with this specification of error that regardless of what decision the reviewing court might reach if it were considering the evidence in the first instance, it could not disturb the trial court's finding unless clearly erroneous."





In the case of *Century Indemnity Co. v. Serafine*, 311 F. 2d 676, at page 679, the Court stated:

"Similarly, the drawing of reasonable inferences from the evidence is a function of the trial court."

Fifth: The trial court may draw inferences favoring either party and, unless "clearly erroneous," the findings and conclusions based thereon will not be disturbed on appeal. (*Walker v. United States*, 180 F. 2d 217; *Flynn v. United States*, *supra*, 205 F. 2d 756; *Weyl-Zuckerman v. Comm. of Int. Rev.*, 232 F. 2d 214 (9th Cir.).)

Sixth: Appellate court cannot substitute its own inferences, even if contrary inferences can be drawn, for those reasonably drawn by the trial court, even though it might disagree with those of the trial court. (*Widney v. United States*, 178 F. 2d 880; *Wunderlich v. United States*, 240 F. 2d 201, Cert. denied 353 U.S. 950.)

Seventh: Appellate court must take the view of the evidence most favorable to the prevailing party below and that party is entitled to all favorable inferences. (*Stacher v. United States*, 248 F. 2d 112 (9th Cir.); *Cashman v. Mason*, 166 F. 2d 693; *United States v. Comstock Extension Mining Co.*, 214 F. 2d 400.)



Eight: Appellate court should adopt a version consonant with the findings, conclusions and judgment of the trial court. (*Elrick Rim Co. v. Reading etc. Co.*, 264 F. 2d (9th Cir.), Cert. denied 360 U.S. 914.)

There is no question but that at the trial Agent Richards testified as follows:

"Q Was anything ever said by you or anyone in your presence to Mr. Sussman that if he would go to Mr. Marchese's apartment, he would -- and cooperate with you, that he would receive a lighter sentence on the criminal matter then pending?

"A It wasn't said in my presence, if it ever was said." (Trial-R.T. 107)

Richards was present at the conference in the office of the Bureau of Narcotics where Sussman was brought immediately after his arrest. At once following such conference, Sussman became a "special agent" and was released on his own recognition and was even paid money during the investigation. We shall not go into all the evidence from which the trial court rightly drew a reasonable inference and made a finding that some promise or assurance was made of the type indicating the possibility of Sussman's receiving a lighter sentence. This Court has summarized the testimony of Richards and Bevan at the hearing in Notes 4 and 5 of the opinion, pages 797 and 798, so we will not repeat it.





An examination of the testimony and evidence justified Judge Clarke in drawing an inference from such facts that some assurance, arrangement or promise was given to Sussman whereby he could expect a lighter sentence and some consideration. Why, otherwise, would a narcotics agent go to so much trouble for a man with a narcotics record, culminating in the most extraordinarily light sentence?

In its opinion, this Court stated that there was "no proof" that Sussman was promised "leniency" as such. There was *proof* that Richards promised Sussman he would do certain things which would normally result in a "lighter sentence," if Sussman cooperated. Richards' testimony was clearly equivocal and he may not have used the exact words of promise indicating the possibility of a lighter sentence. The old maxim, "A rose by any other name will smell just as sweet," is applicable in this case. We submit that the trial judge could infer some agreement or understanding between Sussman and Richards whereby a lighter sentence would normally and probably result in the normal course of events.

In *People v. Nitzberg*, 289 N.Y. 523, 47 N.E. 37, the conviction of the defendant was reversed even though the District Attorney made no specific promise that State



witnesses would receive any benefit in consideration of their testimony; they did obtain such benefits in recognition of their help.

If this Court followed the rules of appellate review as above set forth, it would have upheld the findings and conclusions of the District Court. If any finding should be determined "clearly erroneous," in the light of such rules it should have sustained the judgment on other findings, on the theory that all intendments are in favor of the judgment and that it must be sustained and affirmed if at all possible.

The Court also missed completely the purport of the District Court's finding with respect to the time served by petitioners, amounting to approximately four and one-half years each, and their excellent prison records. The Circuit Court stated that "good time" is a matter for prison authorities, not for courts, and there was no substantial evidence to support the finding that they had "good time." A letter, with respect to Marchese, from the prison authorities was introduced in evidence without objection from the Government, indicating Marchese's excellent prison record<sup>[6]</sup>,

[6] A portion of the letter from the United States Department of Justice, Bureau of Prisons Federal Correctional





and Judge Clarke also had information of Del Bono's good prison record. The Government had full and peculiar information and knowledge of such good prison records and it never at any time during the trial or on appeal denied the statements made or the evidence with respect thereto. If there had been the slightest question as to the correctness of the statements that Marchese and Del Bono had excellent prison records, the Government would have disputed the same, since such records were peculiarly within their knowledge, inasmuch as the Government had custody of petitioners and their prison records.

We concede that "good time" is a matter for the prison authorities, and in this case Judge Clarke only found what the prison authorities had already determined. Since the

[6 continued] Institute, Terminal Island, to Judge Clarke, reads as follows:

"You asked that this report be brief and therefore I will not cover in detail his adjustment at McNeil Island. Generally I can say that it was satisfactory and he maintained a clear conduct record.

"Marchese appealed to the Director and other members of the staff to be permitted to remain at this institution to facilitate family visiting and to aid in matters pending before your Court. He was assigned to our Cullinary Department and close custody quarters because of the nature of his offense and length of sentence. His adjustment was such that after 7 months he was removed from close custody quarters and is now in a regular





prison authorities had already determined that appellants had good records, the amount of good time credit each was entitled to was merely a matter of calculation under the rules prescribed by Sections 4161 and 4163 of Title 18, U.S.C., so Judge Clarke had the calculated credit for good time in mind when he made the findings and rendered the judgment.

However, if this Court, despite acquiescence of the United States Attorney as to the fact of such good prison records, declares the evidence insufficient, we must again point out that the proceedings herein were based upon equitable principles, permitting the trial court to do what is just, fair, equitable and serving the ends of justice. That being true, Judge Clarke, even with little or insufficient evidence, could consider what he learned of the good

[6 continued]

dormitory. He continues to work in our Cullinary Department and is now classified as a butcher's helper. His work reports since arrival have been consistently above average. His reports since January of this year have been predominantly outstanding. Because of this and his participation in other self-improvement activities he was granted an award of 2 days per month extra good time which became effective February 1, 1961. This was increased to include a monetary award of \$10.00 per month for six months, effective April 1, 1962. You may be interested to know that our monetary awards are granted for specifically prescribed periods because of budgetary limitations."



prison records in making his decision to discharge the prisoners. This would be similar to what the trial court may learn through probation reports or even statements of defense and prosecution counsel, in order to decide what sentence it may impose in a given case.

We reiterate that Judge Clarke's intent was to vacate and set aside the sentence and discharge the petitioners. The length of time served by them and their good prison records were considered by him primarily to determine whether it was fair, equitable and serving the ends of justice to discharge them. The words "for time served" were to justify or vindicate somewhat his intent to discharge them.

Even if this Court persists in its view that the evidence was insufficient to sustain findings as to any promise, assurance or agreement between the agents and Sussman, we submit that Judge Clarke could consider what facts surrounded the activities of Agent Richards and the Assistant United States Attorney, in order to do what in his opinion was just, equitable and serving the ends of justice, under both Section 2243 and Section 2255.





## CONCLUSION

In conclusion, we respectfully submit:

1. That the constitutional rights of appellants were invaded and violated under the Fourth, Fifth and Sixth Amendments of the Constitution in the use of the Schmidt transmitter.

2. That the constitutional rights of Marchese were infringed upon when he was arrested and his person and apartment searched without an arrest warrant or a search warrant, although the Government had ample opportunity to do so.

3. That the appellants were denied a fair trial and due process by reason of the fact that Agent Richards admittedly promised to do something for Sussman, to secure him consideration, even though Richards may not have promised or guaranteed him "a lighter sentence" in so many words, and yet no mention of any such arrangement was disclosed at the trial.

4. That even if Assistant United States Attorney Bevan was not deemed to have *suppressed* evidence by the form of objection he made, nevertheless, he *failed to disclose*



activities surrounding the obtaining of great and unusual leniency for Sussman.

5. That due to obvious and patent errors in the opinion of this Court, it should review and revise its opinion and mandate.

6. That if this Court determines on review that the trial court could not, even in the interests of justice, reduce the sentences of appellants or discharge them for time served, as has been done in other circuits, it should authorize and direct the District Court to amend its judgment by vacating and setting aside the judgment of conviction and completely discharge appellants, or this Court itself could order the discharge of the appellants without requiring further proceedings in the District Court. By so doing, we submit, it would be just, fair, equitable and serve the ends of justice.

Respectfully submitted,

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HOCHMAN

Attorneys for Appellant  
Michele Marchese

RUSSELL E. PARSONS

Attorney for Appellant  
Jesse Del Bono



## C E R T I F I C A T E O F C O U N S E L

I certify that, in connection with the preparation of this brief, I have examined Rules 18 and 19 of The United States Court of Appeals for the Ninth Circuit, and that, in my opinion, the foregoing brief is in full compliance with those rules.

---





PROOF OF SERVICE BY MAIL

STATE OF CALIFORNIA            )  
                                      )  
County of Los Angeles        )    ss.

I, the undersigned, say: I am and was at all times herein mentioned, a citizen of the United States and employed in the County of Los Angeles, over the age of eighteen years and not a party to the within action or proceeding; that

My business address is 215 West Fifth Street, Los Angeles, California 90013, that on September       , 1966, I served the within APPELLANTS' OPENING BRIEF (No. 20893) on the following named, by depositing three copies thereof, inclosed in a sealed envelope with postage thereon fully prepaid, in the United States Post Office in the City of Los Angeles, California, addressed to said party at the address as follows:

United States Attorney  
Sixth Floor, Federal Building  
Los Angeles, California

I declare under penalty of perjury that the foregoing is true and correct.

Executed on September       , 1966, at Los Angeles, California.

---

Signature  
(D. A. Standefer)

Orig. & 20 copies:

Clerk, U. S. Court of Appeals  
For the Ninth Circuit  
U. S. Post Office and Court House Bldg.  
San Francisco, California 94101

Subscribed and sworn to before me  
this    day of September, 1966.

---

Notary Public in and for  
the State of California

DEAN-STANDEFER MULTI COPY SERVICE, 215 W. 5th St.  
Los Angeles, California 90013 - MAdison 8-6898.









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APPELLEES' BRIEF

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APPEAL FROM  
THE UNITED STATES DISTRICT COURT  
FOR THE CENTRAL DISTRICT OF CALIFORNIA

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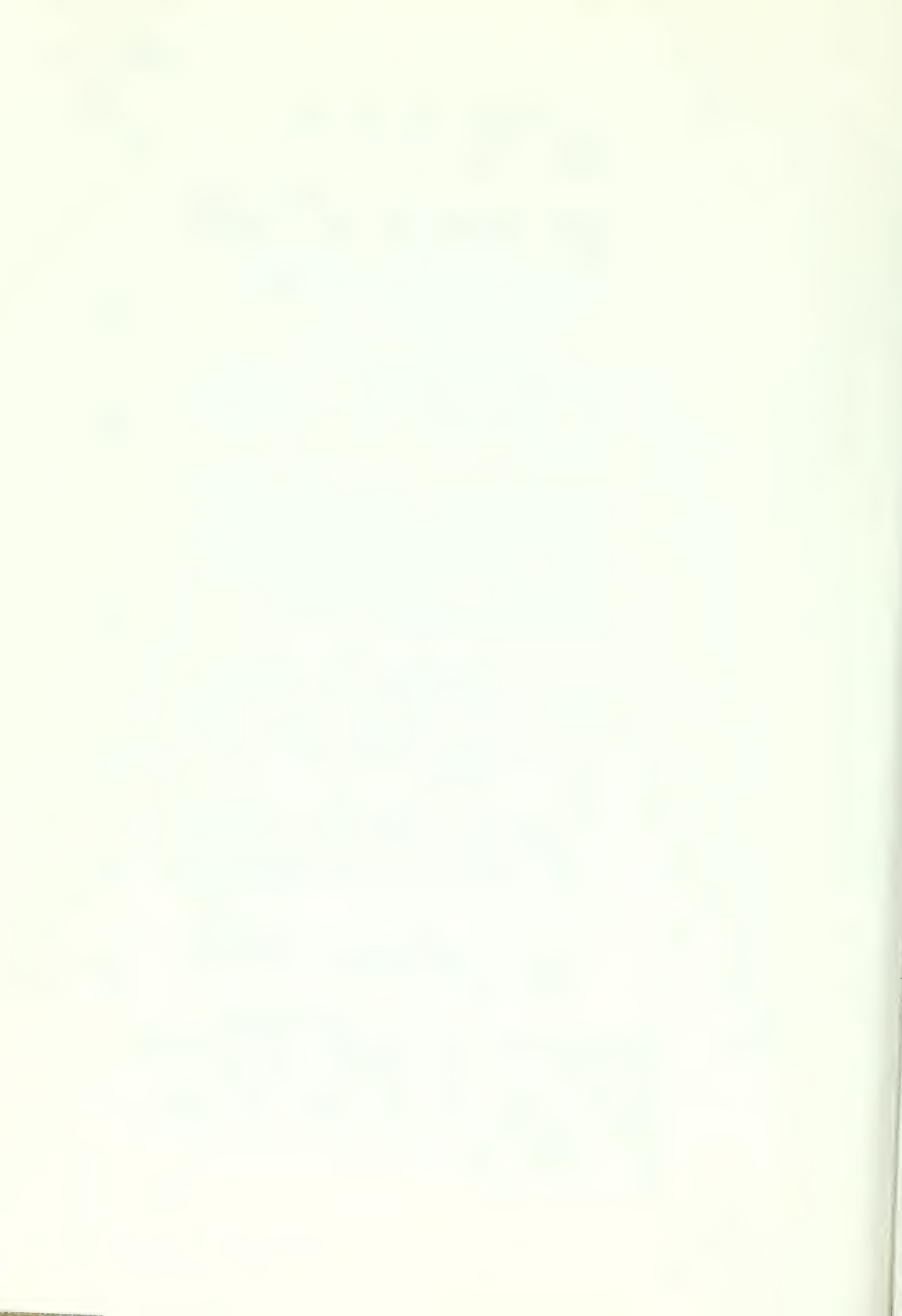
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IN THE UNITED STATES COURT OF APPEALS  
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APPELLEES' BRIEF

---

I

STATEMENT OF PLEADINGS AND FACTS  
CONCERNING BASIS OF JURISDICTION

On November 10, 1965, each appellant filed, in the United States District Court for the Southern District of California, Central Division, a document entitled "Motion to File Amended Findings of Fact and Conclusions of Law and Judgment or in the Alternative to Treat Motion as New Supplemental Motion Under Sections 2243 and 2255 Title 28, U. S. C. " [C. T. 143 and 253]. <sup>1/</sup> Amended findings of fact and conclusions of law, and amended judgments, were lodged simultaneously therewith [C. T. 166-178, 258-268]. The

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1/ Clerk's Transcript.



Government filed an opposition to the two motions on November 19, 1965 [C. T. 151], and, after hearings before the Honorable Thurmond Clarke, United States District Judge, they were denied on January 19, 1966, and again on January 20, 1966 [R. T. 1966, 32, 42]. <sup>2/</sup> An order nunc pro tunc denying the motions and "certifying" the cases to the Court of Appeals for the Ninth Circuit for clarification of its decision, opinion and remand in United States v. Marchese, 341 F.2d 782 (9th Cir. 1965), was entered April 26, 1966 [C. T. 207]. Notice of appeal to this Court were timely filed on January 20, 1966 [C. T. 195 and 277].

At the time the aforementioned motions were made, and at all times thereafter, appellants were at large on bail [C. T. 140, 207, 209]. Thus the District Court was without jurisdiction to entertain the subject motions on the merits under 28 U.S.C. §§ 2241, 2243 or 2255. (See Argument, Point "D", infra.) This Court's jurisdiction is based upon 28 U.S.C. §§ 1291 and 1294.

## II

### STATUTES INVOLVED

Title 28 U.S.C. § 2106, which provides:

"The Supreme Court or any other court of appellate jurisdiction may affirm, modify, vacate, set aside or reverse any judgment, decree, or order of a court lawfully brought before it for review, and

---

<sup>2/</sup> Reporter's Transcript, 1966 Proceedings.





may remand the cause and direct the entry of such appropriate judgment, decree, or order, or require such further proceedings to be had as may be just under the circumstances."

Title 28 U.S.C. § 2241, which provides in part:

"(a) Writs of habeas corpus may be granted by the Supreme Court, any justice thereof, the district courts and any circuit judge within their respective jurisdictions. . . .

\* \* \*

"(c) The writ of habeas corpus shall not extend to a prisoner unless --

\* \* \*

"(3) He is in custody in violation of the Constitution or laws or treaties of the United States; . . . ."

Title 28 U.S.C. § 2243, which provides in part:

"A court, justice or judge entertaining an application for a writ of habeas corpus shall forthwith award the writ or issue an order directing the respondent to show cause why the writ should not be granted, unless it appears from the application that the applicant or person detained is not entitled thereto.



"The court shall summarily hear and determine the facts, and dispose of the matter as law and justice require."

Title 28 U. S. C. § 2244, which provides:

"No circuit or district judge shall be required to entertain an application for a writ of habeas corpus to inquire into the detention of a person pursuant to a judgment of a court of the United States, or of any State, if it appears that the legality of such detention has been determined by a judge or court of the United States on a prior application for a writ of habeas corpus and the petition presents no new ground not theretofore presented and determined, and the judge or court is satisfied that the ends of justice will not be served by such inquiry."

Title 28 U. S. C. § 2255, which provides:

"A prisoner in custody under sentence of a court established by Act of Congress claiming the right to be released upon the ground that the sentence was imposed in violation of the Constitution or laws of the United States, or that the court was without jurisdiction to impose such sentence, or that the sentence was in excess of the maximum authorized



by law, or is otherwise subject to collateral attack, may move the court which imposed the sentence to vacate, set aside or correct the sentence.

"A motion for such relief may be made at any time.

"Unless the motion and the files and records of the case conclusively show that the prisoner is entitled to no relief, the court shall cause notice thereof to be served upon the United States Attorney, grant a prompt hearing thereon, determine the issues and make findings of fact and conclusions of law with respect thereto. If the court finds that the judgment was rendered without jurisdiction, or that the sentence imposed was not authorized by law or otherwise open to collateral attack, or that there has been such a denial or infringement of the constitutional rights of the prisoner as to render the judgment vulnerable to collateral attack, the court shall vacate and set aside the judgment and shall discharge the prisoner or re-sentence him or grant a new trial or correct the sentence as may appear appropriate.

"A court may entertain and determine such motion without requiring the production of the prisoner at the hearing.

"The sentencing court shall not be required to entertain a second or successive motion for similar





relief on behalf of the same prisoner.

"An appeal may be taken to the court of appeals from the order entered on the motion as from a final judgment on application for a writ of habeas corpus.

"An application for a writ of habeas corpus in behalf of a prisoner who is authorized to apply for relief by motion pursuant to this section, shall not be entertained if it appears that the applicant has failed to apply for relief, by motion, to the court which sentenced him, or that such court has denied his relief, unless it also appears that the remedy by motion is inadequate or ineffective to test the legality of his detention. "

### III

#### STATEMENT OF THE CASE

##### A. History of Prior Proceedings.

---

The history of the Marchese and Del Bono cases up to June 1963 is set forth in this Court's opinion in United States v. Marchese, 341 F.2d 782, 784-786 (9th Cir. 1965), as follows:

"(1) On June 16, 1958, appellees [appellants herein] were each convicted following a jury trial for violation of 18 U.S.C. § 371 and 21 U.S.C. § 174 -- sale of more than two pounds of heroin.



"(2) The judgments of conviction were affirmed by this court per curiam on April 15, 1959 [Marchese v. United States, 264 F.2d 892 (9th Cir. 1959)].

"(3) Petitions for certiorari were denied by the United States Supreme Court -- Marchese v. United States, 360 U.S. 930, 79 S.Ct. 1447, 3 L.Ed.2d 1543 (1959); Del Bono v. United States, 360 U.S. 938, 79 S.Ct. 1463, 3 L.Ed.2d 1550 (1959).

"(4) Marchese and then Del Bono filed motions to annul, vacate and set aside their judgments of conviction under the provisions of 28 U.S.C. § 2255 . . . . Both were denied on December 22, 1960 by the Honorable Thurmond Clarke, the same judge who had tried the appellees earlier. No appeal was taken by either appellee.

"(5) On February 3, 1961, each filed motion for reconsideration of the court's order denying the § 2255 motions. On March 14 and 15, 1961, each was again denied.

"(6) On June 20, 1961, Marchese filed a petition for a writ of habeas corpus. This was denied by another district court judge, the Honorable Peirson M. Hall. Marchese appealed, and this court affirmed that denial. [Marchese v. United States, 304 F.2d 154 (9th Cir. 1962)].

"(7) Marchese then filed a petition in the United





States Supreme Court for a writ of certiorari.

"(8) Del Bono had meanwhile filed a new motion under 28 U.S.C. § 2255, which was denied by Judge Thurmond Clarke on December 27, 1961. No appeal was taken.

"(9) The United States Supreme Court granted Marchese's petition for certiorari, and remanded the case to the district court for 'reconsideration in the light of Sanders v. United States, 373 U.S. 1 [83 S.Ct. 1068, 10 L.Ed.2d 148]. ' ' [Marchese v. United States, 374 U.S. 101, 83 S.Ct. 1686, 10 L.Ed.2d 1026 (1963)].

On September 30, 1963, subsequent to the remand by the Supreme Court and following a hearing in the District Court, Judge Clarke ordered appellant Marchese's ten year sentence "modified, reduced and corrected to be five years", and further ordered appellant Marchese ". . . immediately released from custody", by judgment entered September 30, 1963 [C. T. 129]. Findings of fact and conclusions of law were filed at the same time [C. T. 120]. Thereafter, on November 12, 1963, appellant Del Bono filed a "Petition to Annul, Vacate and Set Aside and/or Modify the Judgment of Conviction Rendered Herein in case No. 26762-CD . . . Pursuant to the Provisions of Title 28, U.S.C.A., Section 2255 and Section 2243" [C. T. 211]. Following a hearing Judge Clarke granted the Del Bono petition, by written order of December 18,



1963, entitled "Order Granting Motion for Modification of Sentence" [C. T. 236]. Then on December 20, 1963, Judge Clarke signed Findings of Fact and Conclusions of Law and a Judgment, which ordered relief identical to that previously provided appellant Marchese [C. T. 238-245].

The petition which obtained for appellant Marchese his release from custody was based upon the following grounds:

1. The judgment of conviction by the use of "silver platter" evidence was in violation of the Due Process Clause of the Constitution of the United States;

2. The use by the Government of an informant, one Donald Sussman, for the purpose of ensnaring Marchese was pursuant to an agreement and conspiracy between him and federal and state authorities, whereby he would receive money, narcotics, favoritism and leniency, in return for his cooperation;

3. During Marchese's trial, the Assistant United States Attorney abused the privileges of his office by actively participating in the suppression of the truth and failing to disclose the truth concerning an agreement or understanding between Sussman and the federal and state authorities, contrary to his oath of office and in disregard of Marchese's constitutional rights under the Fifth Amendment;



4. The use of evidence obtained by an electronic transmitting device known as a Schmidt transmitter was unlawful and violative of the Fourth Amendment of the Constitution and hence could not support the judgment of conviction;

5. The arrest of Marchese without a warrant of arrest, the search of his person and of his apartment, along with the search of an automobile driven by Del Bono, as well as other searches without a search warrant, were all in violation of the Fourth Amendment;

6. Evidence obtained by an unauthorized interception of a telephone conversation was in violation of 47 U.S.C. § 605 [C. T. 2, 13-14].

The Del Bono petition was founded upon grounds the same as grounds three and four of the Marchese petition, *supra* [C. T. 211, 219-222].

With respect to both appellants, the findings filed in the 1963 proceedings set out at length the "facts" upon which each of the above grounds was based [C. T. 120, 238; United States v. Marchese, 341 F.2d 782, 790-793 (9th Cir. 1965)]. The conclusions of law drawn therefrom, identical in the case of each of the appellants, stated, in effect, that the District Court had jurisdiction to grant the requested relief either on a petition for writ of habeas corpus, or on a Section 2255 motion; that their constitutional rights to a fair trial were so denied and infringed as to render their





convictions subject to collateral attack and that their rights under the Fourth and Fifth Amendments were so denied and infringed as to amount to a denial of due process of law in violation of the Fourteenth Amendment; and, finally, that it would be fair, equitable and just to modify, reduce and correct their sentences, and that their immediate release from custody would be appropriate because of "good time" earned [C. T. 120, 126-127, 238, 244-245].

From the judgments of the District Court, appeals were taken by the United States to the Court of Appeals for the Ninth Circuit, notices of appeal having been timely filed on November 27, 1963 with respect to Marchese, and February 17, 1964 with respect to Del Bono [C. T. 136, 248]. The Government's opening brief on those appeals (Nos. 19172 and 19249) raised and discussed the following points:

"A. The judgments of the District Court 'modifying and reducing' appellees' sentences and awarding them 'good time', exceeded the statutory jurisdiction conferred by Title 28 U. S. C. Section 2255.

\* \* \*

"B. Title 28 U. S. C. Section 2255 may not be invoked to relitigate questions which were or should have been raised on a direct appeal from the judgment of conviction.

"C. Appellees have alleged but have not proved such a denial or infringement of their



constitutional rights as would render their conviction vulnerable to collateral attack.

\* \* \*

"D. The findings of fact were 'clearly erroneous' within the meaning of Rule 52a, Federal Rules of Civil Procedure. \* \* \* " (Appellants' Opening Brief, Appeals Nos. 19172 and 19249, pp. 23-78).

Under Point "C", the Government critically analyzed each of the six grounds for relief urged by Marchese in his petition, listed above.

On February 10, 1965, this Court rendered its decision in United States v. Marchese, 341 F.2d 782 (9th Cir. 1965). It was simply, that "[e]ach judgment is reversed, and appellees ordered remanded to custody forthwith". 341 F.2d at 801. Rehearing was denied, on March 3, 1965. A petition for a writ of certiorari was denied by the Supreme Court. Marchese v. United States, 382 U.S. 817, 15 L. Ed. 2d 64 (1965).

The sequence of subsequent events has been recounted in the Statement of Pleadings and Facts Concerning Basis of Jurisdiction, supra. It should be noted that at the hearings in the District Court on January 19 and 20, 1966, Judge Clarke spread the mandate of this Court, in addition to denying appellants' motions [R. T. 1966, 32, 42].

At the January 5, 1966, hearing on appellants' motions to file amended findings, etc., Mr. Hochman, one of Marchese's





attorneys, summarized their position as follows:

"First of all, we argue that the court does have jurisdiction within the law of the case, and in general, to review and to free these men in accordance with the amended findings of fact, conclusions of law, and proposed judgments as now prepared.

"Secondly, and in the alternative, if in the interpretation of what is the jurisdiction of the court, the court feels that it does not have that particular jurisdiction, the court does have jurisdiction to treat the moving papers as an alternative writ, since it has been long held that there is no res judicata on these particular matters.

\* \* \*

"Now, what the Court of Appeals, we feel, was saying here was that of the four alternatives available to the [District Court] [i. e., "(1) 'vacate and set the judgment aside and \* \* \* discharge the prisoner,' or (2) 'resentence him,' or (3) 'grant a new trial,' or (4) 'correct the sentence,' " -- quoting from portion of opinion in United States v. Marchese, supra, 341 F.2d at 787-788, wherein this Court sets out the kinds of relief authorized by Section 2255], had this Court availed itself of alternative (1), (2) and (3), it is our considered opinion and judgment that the order of the court would have been affirmed.



" . . . The Court of Appeals then proceeds on page 20 of the corrected slip opinion to set forth what has troubled petitioners herein. I quote from page 20 of the corrected slip opinion [United States v. Marchese, supra, 341 F.2d at 794, wherein the deficiencies in the findings of fact filed in 1963 are discussed].

\* \* \*

" . . . That there were no conclusions of law predicated on the findings of fact with which the Circuit could address itself, in our considered opinion, commends itself to your Honor in view of the present amended findings of fact, conclusions of law, proposed to your Honor, that had these conclusions of law been in ab initio, your Honor would have been affirmed. And in that they are now more important, if your Honor grants petitioners' request, your Honor would be affirmed.

" . . . The whole problem of the Schmidt radio receiver and overheard telephone conversations will again be litigated in our District Courts, in the Court of Appeals for this Circuit, and undoubtedly before the Supreme Court." [R. T. 1966, 5-12].

Mr. Parsons, counsel for Del Bono, made, among others, the following statements at that hearing:

"Then in reversing the judgment the Circuit



Court stated:

" 'Having determined that the District Court erred in one, exceeding its jurisdiction in granting unauthorized relief; two, making insufficient findings to permit this court to ascertain upon what its conclusions were based;' -- [Quoting from United States v. Marchese, supra, 341 F.2d at 801]

obviously we respectfully contend that this court is with jurisdiction, and while they didn't say so in so many words, it is almost a direction for this matter to be reheard by this court and proper findings and conclusions upon which they could base proper findings be drawn.

" . . . In reversing this judgment we think that the Circuit Court disregarded longstanding rules regarding the respective rights and duties of both appellate and trial courts.

\* \* \*

"The trial court may draw inferences favoring either party, and unless clearly erroneous the findings and conclusions based thereon will not be disturbed on appeal. \* \* \* " [R. T. 1966, 12-16].

At the hearing held on January 19, 1966, the District Court stated its views as follows:





"We have given a great deal of thought to this matter, and about all I can say is the Circuit decision, in other words, seems to bind the Court. I feel that it is somewhat ambiguous, but there is nothing I can do. So all I can do is have the petitioners' motions denied and the defendants remanded . . . ."

[R. T. 1966, 29-30].

During that hearing, the Court expressed further concern regarding its duties under the Mandate of this Court:

"MR. MARKS [Counsel for Marchese]: Well, this is the problem: . . . The opinion of the Circuit Court is somewhat ambiguous and it is not quite clear what discretion this court has under the circumstances. Therefore, I think this court has the power to certify that question back to the Circuit Court to clarify for this court's satisfaction what it has the power to do under the circumstances of the mandate to this court.

"THE COURT: Well, I can do that automatically, by spreading the mandate, certifying it back to the Circuit Court and, also, at that time approve the bonds.

\* \* \*

"THE COURT: Well, I imagine Mr. Hochman's thought is that it might help somebody up there in the Circuit Court if I certify it, that they will give it their undivided attention.



\* \* \*

"THE COURT: I stated it is rather ambiguous, I stated that right from the bench; and I think that will be a fair matter, and then that will give them another look at it, is really what it amounts to." [R. T. 1966, 37-38].

Appellants are presently at large, the District Court having ordered that they remain on bail pending the instant appeal [C. T. 207].

#### IV

#### SUMMARY OF ARGUMENT

The District Court was obligated to follow the mandate of this Court, and thus properly refused to grant relief inconsistent therewith. The decision of this Court in United States v. Marchese, 341 F.2d 782 (9th Cir. 1965), ordered appellants remanded to custody forthwith, and did not contemplate any remand of the cause to the District Court for further proceedings, or for the filing of amended findings of fact, conclusions of law, or judgments.

The several grounds for relief urged in the petitions granted by the District Court in 1963 were, with one exception, held in United States v. Marchese, to be insufficient as a matter of law, particularly where they were in fact raised on prior appeals and determined adversely to appellants. There was only one ground





which could, if proven, have compelled their release from custody, and the District Court's finding with respect to it was held by this Court to be totally without evidentiary support. The amended findings of fact and conclusions of law sought to be filed by appellants reveal no new grounds.

In view of this Court's decision and opinion in United States v. Marchese, the instant appeal represents an improper attempt to relitigate issues which have been conclusively laid at rest.

## V

### ARGUMENT

- A. EVERY ISSUE RAISED BY THE AMENDED FINDINGS OF FACT AND CONCLUSIONS OF LAW WHICH APPELLANTS HAVE SOUGHT TO FILE WAS DETERMINED ADVERSELY TO THEM IN UNITED STATES v. MARCHESE, 341 F.2d 782 (9th Cir. 1965), AND THE AMENDED FINDINGS AND CONCLUSIONS FAIL TO DISCLOSE ANY BASES FOR RELIEF UNDER 28 U. S. C. SECTION 2255.
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By their motions to "File Amended Findings of Fact and Conclusions of Law and Judgment or in the Alternative to Treat Motion as New Supplemental Motion, etc.", appellants obviously sought to obtain relief from the District Court which was in no way sanctioned in United States v. Marchese, 341 F.2d 782 (9th Cir. 1965), and totally contrary thereto. Although the motions merely asked permission to "file and lodge" amended findings of fact and conclusions of law and amended judgments, doubtless it was



appellants' hope that these documents would be signed by the District Court, that judgments would be entered, and that they would be once and for all discharged from custody.

Appellants appear to take the position that the decision in United States v. Marchese, amounted essentially to a holding that the original findings of fact and conclusions of law were inartfully drawn, for they say:

"The language of the Circuit Court, in its opinion, certainly authorizes, if it does not require, the District Court to make new and amended findings of fact and conclusions of law, to render an amended judgment based thereon, and afford relief to appellants within its jurisdiction, power and authority prescribed by this Court under Section 2255.

"In accordance with the requirements of the opinion, appellants moved to file amended findings of fact and conclusions of law [C. T. 166-177, 258-268] and amended judgments [C. T. 179-181, 269-271] wherein the District Court would grant the proper relief permitted or required by the opinion. "  
(Appellants' Opening Brief, 30-31).

Following this interpretation of the opinion, they made their motions to file amended findings of fact, conclusions of law, and amended judgments.

On comparing the "amended" findings of fact with those



filed in the 1963 proceedings [C. T. 120-128, 238-245], it becomes apparent that they amount to nothing more than a slightly refurbished presentation of the contents of the prior findings. 3/

Amended Finding I is both a finding and a non-finding.

After reciting facts apparently designed to show that the informant had received at least a "hint" that he would be accorded lenient treatment in pending state and federal prosecutions against him, it reads:

"In view of the opinion and findings of the Circuit Court, this Court now makes no finding on the issue and contention of petitioner that Sussman was promised that he would receive a lighter sentence on the criminal matter then pending if he cooperated with the government agents." [C. T. 168-169, 260-261] [Cf. Finding of Fact I, 1963, C. T. 120, 239).

Amended Finding VI is also a finding and non-finding. It sets forth the facts upon which appellants originally based their claim that the Assistant United States Attorney who prosecuted them suppressed evidence and knowingly failed to disclose the truth

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3/ In both the Marchese and Del Bono cases, the amended findings and conclusions are identical, with the exception of amended finding IX of the Del Bono findings, and finding X of the Marchese findings, both of which concern arrests, searches and seizures. Amended Finding IX of Marchese's amended findings pertains to the overhearing, by a federal agent, of telephone conversations between Sussman and Marchese; no conclusion of law is drawn from it. The amended conclusions of law are identical in both cases [C. T. 166-178, 258-268].





concerning an alleged agreement that the informant would receive leniency in return for his participation in the investigation of Marchese and Del Bono. After quoting from the portion of the trial transcript wherein the alleged suppression took place, Amended Finding VI states:

"That in view of the findings made by the Circuit Court, this Court now makes no finding on the issue and contention of petitioner that the United States Attorney abused the privilege of his office by suppressing and failing to disclose the truth, and makes no finding as to whether there was an improper agreement between the Assistant United States Attorney and Sussman." [C. T. 171, 263-264] [Cf. Finding of Fact VI, 1963, C. T. 122-124, 240-242].

Amended Findings II through V further elaborate upon the "facts" concerning the relationship between Sussman and the federal and state authorities, particularly with respect to lenient treatment received by him [C. T. 169-171, 261-263] [Cf. Findings of Fact II through V, 1963, C. T. 121-122, 239-240].

Amended Finding VII describes Sussman's bad character, his addiction to, and use of, narcotics, and the government's condoning and consenting to his commission of crimes [C. T. 172, 264] [Cf. Finding of Fact VII, 1963, C. T. 124, 242].

Amended Finding VIII relates facts concerning the use of a Schmidt transmitter, attached to the person of the informant



Sussman, which was employed in obtaining statements made by appellant Marchese in his apartment [C. T. 172, 264-265] [Cf. Finding of Fact VIII, 1963, C. T. 125, 243].

Amended Finding IX describes the activities of a federal agent in placing his ear next to the receiver of a telephone being used by the informant in a conversation with Marchese, so as to overhear what Marchese said, and states that the agent was permitted over objection to testify to what he heard [C. T. 173] [Cf. Finding of Fact IX, 1963, C. T. 125]. <sup>4/</sup>

Marchese's Amended Finding X states that he was arrested without a warrant of arrest; that an automobile, not in his possession, was searched without a warrant by Government agents and the informant, and narcotics removed, without a search warrant; and that following Marchese's arrest, his apartment was searched, although no narcotics nor marked money was found [C. T. 173] [Cf. Finding of Fact X, 1963, C. T. 126]. Similarly, Del Bono's Amended Finding IX states that he was arrested without a warrant; and that the aforementioned automobile was searched, and narcotics removed, without a warrant [C. T. 265] [Cf. Finding of Fact IX, 1963, C. T. 243].

Marchese's Amended Finding XI and Del Bono's Amended Finding X set forth their good prison conduct and the quantities of

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<sup>4/</sup> In United States v. Marchese, it was pointed out, 341 F.2d at 789, that the "intercepted" evidence issue had been disposed on the original appeal from the judgments of conviction (Marchese v. United States, 264 F.2d 892 (9th Cir. 1959)). Again, it is to be emphasized that no conclusion of law was drawn from Amended Finding IX (Marchese).





"good time" earned by them, as well as the amount of time already served by them under their 1958 convictions [C. T. 173, 265] [Cf. Finding of Fact XII (Marchese), 1963, C. T. 126; Finding of Fact XI (Del Bono), 1963, C. T. 243-244].

Marchese's Amended Finding XII and Del Bono's Amended Finding XI state "That the ends of justice are served by inquiring into the merits of this application, whether or not there has been a prior determination on the merits either by appeal or by similar application and that any prior determination, if any on the merits, is not res judicata. " [C. T. 173-174, 265] (Emphasis added).

The amended findings vary from the original findings insofar as the "suppression of evidence" ground is concerned, in that they expressly avoid it; otherwise, no changes of any substance can be found.

The amended conclusions of law are considerably expanded, as compared with those filed in 1963.

Amended Conclusion I is, pertinently, as follows:

"[T]hat by reason of the fact that at the hearing Richards testified that he did in fact tell Sussman he would call to the attention of the United States Attorney whatever Sussman did to make out a case against the source of his supply, and that he would talk to the state officers and see what could be done in Sussman's behalf, . . . and that as a consequence of Richards activities and the carrying out of his promise to Sussman, the latter received



great leniency . . . , the Court concludes it would be fair, equitable and serve the ends of justice . . . to vacate and set aside the judgment of conviction and discharge petitioner." [C.T. 174, 266].

In United States v. Marchese, 341 F.2d at 797-798, this Court concluded:

"[T]here was no proof that defendant Sussman was promised 'leniency' as such. He was promised by Richards: (a) that whatever Sussman did to aid the prosecution 'would be brought to the attention' of the United States Attorney; (b) that Richards, the Federal Bureau of Narcotics agent, told the State probation officer Sussman was 'aiding' the federal government, and was giving the federal government, 'help and cooperation'; that he was 'helping', and Bevan, the Assistant United States Attorney did prepare the lesser tax counts for Sussman's plea, and subsequent imprisonment."

The Court held that the foregoing facts, in and of themselves, did not deprive appellants of a fair trial, or deprive them of any of their constitutional rights. 341 F.2d at 799.

Amended Conclusion of Law II raises the issue whether the use of an informant and "undercover" agent who is known to be a user of narcotics is a denial of "a fair trial and due process". In United States v. Marchese, supra, it was observed that this point had been raised on the original appeal by Marchese and Del Bono



from their convictions. 341 F.2d at 789. Undoubtedly, it was one of the issues which the Court regarded as so lacking in merit as not to be worthy of further consideration. 341 F.2d at 789.

Amended Conclusion of Law IV, in connection with Amended Finding of Fact IX, raises the same arrest, search and seizure issues which were before this Court in United States v. Marchese, 341 F.2d at 787, 793. It is to be emphasized that the search of appellant Marchese's person and apartment at the time of his arrest did not, as stated in both the original and amended findings, result in the discovery of any evidence sought to be used at his trial [C. T. 126, 173]. As for the narcotics which were removed from the automobile "not in Marchese's possession", such removal was accomplished pursuant to Marchese's specific instructions. The informant, Sussman, testified as follows:

" . . . [H]e [Marchese] told me that a blue 1941 Dodge would be parked in that immediate vicinity at approximately 12:30. . . . And he told me to make sure not to be there before time. After I picked up the package, for me to bring the money to him at his apartment, and knock on the door and just say 'Danny' and he would come out. " [Trial R. T. 394-395]. 5/

It was only after receiving these instructions that Sussman retrieved the package from where Marchese had said it would be

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5/ Reporter's Transcript, 1958 Trial of Marchese and Del Bono.





[Trial R. T. 395]. Furthermore, even if this removal were held to amount to an illegal search and seizure, which is not in any way conceded here, it was not one of which Marchese could complain. The general rule in determining whether one is an "aggrieved party" to complain of a search and seizure was stated in Jones v. United States, 362 U.S. 257, 261, 80 S.Ct. 725, 4 L.Ed. 2d 697 (1960) as follows:

"In order to qualify as a 'person aggrieved by an unlawful search and seizure' one must have been a victim of a search or seizure, on against whom the search was directed, as distinguished from one who claims prejudice only through the use of evidence gathered as a consequence of a search or seizure directed at someone else. Rule 41(e) [F.R. Crim. P.] applies the general principle that a party will not be heard to claim a constitutional protection unless he 'belongs to the class for whose sake the constitutional protection was given.' New York ex rel. Hatch v. Reardon, 204 US 152, 160, 51 L.ed 415, 422, 27 S Ct. 188, 9 Ann Cas 736."

See also:

Ramirez v. United States, 294 F.2d 277  
(9th Cir. 1961).

Here the automobile in question was not in Marchese's possession, and the finding does not indicate that it even belonged to him. In fact, in his original petition, Marchese alleged that it was "driven"



by Del Bono [C. T. 13].

Conclusion V of the Amended Findings of Fact and Conclusions of Law states that in view of the time served by appellants, and by virtue of their good prison records and the accumulation of "good time", it would be "fair, just and equitable and serve the ends of justice to vacate and set aside the judgment[s] of conviction and discharge petitioner[s]". It is curious that appellants should now attempt to rely on such a ground, in view of the fact that it was directly, expressly and conclusively held not to be a basis for collateral relief in United States v. Marchese, 341 F.2d at 788.

Amended Conclusions of Law III and VI pertain to the use of the Schmidt transmitter. This was another issue disposed of by the Court in United States v. Marchese, 341 F.2d at 789, as being totally without merit, particularly where it had previously been raised upon appellants' appeal from their judgments of conviction, Marchese v. United States, 264 F.2d 892 (9th Cir. 1959), cert. den., 360 U.S. 930, 79 S.Ct. 1447, 3 L.Ed.2d 1543 (1959), and Del Bono v. United States, 360 U.S. 938, 79 S.Ct. 1463, 3 L.Ed.2d 1550 (1959).

They take the position that the case of On Lee v. United States, 343 U.S. 747, 72 S.Ct. 967, 96 L.Ed. 1270 (1952), is no longer the law, or at least that the instant case is distinguishable. Their primary source of comfort would appear to be Lopez v. United States, 373 U.S. 427, 83 S.Ct. 1381, 10 L.Ed.2d 462 (1963).

In Lopez, the facts were these: The petitioner, Lopez, offered bribes to an Internal Revenue Agent. The agent pretended





to cooperate with Lopez, and in a subsequent meeting with him, was outfitted with a battery-powered pocket transmitter and a pocket wire recorder. Although the transmitter failed to operate, the wire recorder functioned properly, and recorded a conversation between Lopez and the agent. Prior to trial, Lopez moved to suppress as evidence the wire recording of the aforementioned conversation; however, the motion was denied and the recording received in evidence.

On appeal, Lopez asserted that his constitutional rights under the Fourth Amendment had been violated, his theory being that, in view of the agent's alleged falsification of his mission, he gained access to Lopez' office by misrepresentation, and all evidence obtained there was illegally seized.

Speaking for the majority, Mr. Justice Harlan stated:

"Davis was not guilty of an unlawful invasion of petitioner's office simply because his apparent willingness to accept a bribe was not real. Compare Wong Sun v. United States, 371 U.S. 471, 9 L. Ed.2d 441, 83 S. Ct. 407. He was in the office with petitioner's consent, and while there he did not violate the privacy of the office by seizing something surreptitiously without petitioner's knowledge.

" . . .

"Once it is plain that Davis [the agent] could properly testify about his conversation with Lopez,  
the constitutional claim relating to the recording of



that conversation emerges in proper perspective.

. . . Indeed this case involves no 'eavesdropping' whatever in any proper sense of that term. The Government did not use an electronic device to listen in on conversations it could not otherwise have heard.

Instead, the device was used only to obtain the most reliable evidence possible of a conversation in which the Government's own agent was a participant and which that agent was fully entitled to disclose.

. . .

"Stripped to its essentials, petitioner's argument amounts to saying that he has a constitutional right to rely on possible flaws in the agent's memory, or to challenge the agent's credibility without being beset by corroborating evidence that is not susceptible of impeachment.

. . .

"The function of a criminal trial is to seek out and determine the truth or falsity of the charges brought against the defendant. Proper fulfillment of this function requires that, constitutional limitations aside, all relevant, competent evidence be admissible, unless the manner in which it has been obtained -- for example, by violating some statute or rule of procedure -- compels the formulation of a rule excluding its introduction in a federal court.



. . .

"When we look for the overriding considerations that might require the exclusion of the highly useful evidence involved here, we find nothing." (Emphasis added). 373 U.S. 427, 438-440.

Concurring in the result, the Chief Justice agreed with the dissent of Mr. Justice Brennan insofar as the continued vitality of On Lee was concerned. 373 U.S. 427, 441. But he distinguished the On Lee case, as follows:

"When On Lee was arrested, the only direct evidence that he was engaged in the distribution of opium was the unreliable testimony of an alleged accomplice who handled the contacts with purchasers. . . . To strengthen its case against On Lee, the Government sent a 'special employee,' one Chin Poy, into On Lee's laundry armed with a concealed transmitter, On Lee being out on bail pending indictment at the time . . . Chin Poy . . . engaged On Lee in conversation for the purpose of eliciting admissions that On Lee was part of an opium syndicate and to encourage him to commit another crime. At trial, instead of calling Chin Poy to testify, the Government put on the narcotics agent who had been at the receiving end of the radio contact with Chin Poy to testify to the admissions made by On Lee . . . .





"The use and purpose of the transmitter in On Lee was substantially different from the use of the recorder here. Its advantage was not to corroborate the testimony of Chin Poy, but rather, to obviate the need to put him on the stand." 373 U.S. 427, 442-443. (Emphasis added)

Quoting from the On Lee Opinion, the Chief Justice pointed out that it was probably to avoid putting such an unsavory character as Chin Poy before the Jury that the transmitting device was used at all. 373 U.S. 427, 443.

In the instant case, the Government had no such ulterior motive in equipping the informant Sussman with the Schmidt transmitter since he was called as a witness and testified at length at the 1958 trial [Trial R. T. 359-399].

It should be noted that appellants, in their Opening Brief herein, make the claim that the instant state of facts is materially distinguishable from those in On Lee:

"On Lee may be distinguished from the instant case in that here the transmission took place in Marchese's private apartment, where in On Lee the transmission took place in the public portion of On Lee's laundry, . . . and also on the sidewalks of New York." (Opening Brief, p. 14).

In the Lopez case, supra, the clandestine recording was made in the petitioner's office. And certainly, where, as here, Marchese elected to ply his trade from his apartment, it is difficult to see



how his apartment could stand on a different footing from an office, where the subject conversations related to "business". Thus the "distinction" they have pointed to is obviously without substance.

It should also be noted, parenthetically, that appellant Del Bono is really in no position to complain about the admission of evidence obtained by use of the Schmidt transmitter, where the relevant findings of fact fail to state that anything said by him was transmitted or received, and in fact that the subject conversations were between the informant and appellant Marchese, and do not indicate that Del Bono was even present when they took place [Amended Finding VIII, C. T. 264].

See: Jones v. United States, supra, 362 U.S. 257, 261,  
80 S. Ct. 725, 4 L. Ed. 2d 697 (1960);  
Ramirez v. United States, supra, 294 F.2d 277  
(9th Cir. 1961).

Appellants have sought to liken the instant case to Massiah v. United States, 377 U.S. 201, 84 S. Ct. 1199, 12 L. Ed. 2d 246 (1964) and Escobedo v. Illinois, 378 U.S. 478, 84 S. Ct. 1758, 12 L. Ed. 2d 977 (1964). In Massiah it was held that where, after indictment, the defendant had a conversation in the absence of his retained counsel with one of his codefendants while sitting in the latter's automobile, unaware that, with the codefendant's cooperation, government agents had installed a radio transmitter, the use of evidence obtained by the transmitter was improperly introduced in evidence in that it violated the defendant's Sixth Amendment right to counsel. Escobedo held that a conviction must be





set aside, as violative of the Sixth Amendment, where the accused requested, but was denied, the presence of his lawyer while being interrogated by the police after the investigation had focused on him, and evidence obtained by the interrogation was received at the subsequent trial.

In the case at bar, it does not appear that appellants had been indicted, that they had retained counsel for the purpose of handling their trial, or that they ever made any request to see an attorney at the time the conversations were picked up by the transmitter.

According to the Opening Brief herein, there are cases pending before the Supreme Court of the United States which involve the use of "bugging" and concealed transmitting devices, including Miller v. United States, Black v. United States and Kolod v. United States. As far as counsel has been able to determine, the Black and Kolod cases involve the classic "bugging" or eavesdropping situations. (Nothing could be found on the Miller case.) Corroborative electronic listening aids, such as that involved in the instant case, are an entirely different matter from what was involved in Black and Kolod. At any rate, even in the highly unlikely event that the Supreme Court handed down a decision holding that the use of evidence obtained by such a device as the Schmidt transmitter, under facts similar to the instant case, violated an accused's constitutional rights, it is very questionable whether it would be applied retroactively.



See: Linkletter v. Walker, 381 U.S. 618, 85 S.Ct. 1731,  
14 L.Ed.2d 601 (1965);  
Johnson v. New Jersey, 16 L.Ed.2d 882 (1966);  
Lee v. Wilson, 363 F.2d 824 (9th Cir. 1966);  
Lester v. Wilson, 363 F.2d 824 (9th Cir. 1966).

B. IF VIEWED "IN THE ALTERNATIVE"  
AS "NEW, SUPPLEMENTAL MOTIONS",  
THE SUBJECT MOTIONS CONSTITUTE  
AN ATTEMPT TO RELITIGATE MAT-  
TERS WHICH WERE DETERMINED  
ADVERSELY TO APPELLANTS IN  
UNITED STATES v. MARCHESE, 341  
F.2d 782 (9th Cir. 1965).

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Even if the motions are to be viewed "in the alternative" as "new, supplemental motions", they offer nothing new. One would expect to find a fresh list of grievances set forth, but they fail to allege a single new ground of relief. Rather, the motions say simply:

"If for any reason this Court does not believe it has jurisdiction and authority to amend said Findings, Conclusions and Judgment petitioner in the alternative, requests the Court to treat this as a new or supplemental motion under Section 2243 and 2255 of Title 28, U.S.C. and incorporates by reference the original petition and motion except as to that portion thereof: [citing portions to be omitted]."  
[C. T. 143, 144, 253, 254] (Emphasis added)



It was from the granting of the aforementioned original petitions that the Government appealed in United States v. Marchese. By eliminating the "silver-platter" and suppression of evidence grounds, and seeking relief upon otherwise identical grounds again, after reversal by this Court, appellants were patently attempting nothing more nor less than an evasion of the mandate therein.

C. THE DISTRICT COURT WAS REQUIRED STRICTLY TO FOLLOW THE MANDATE OF THE COURT OF APPEALS, AND COULD NEITHER INTERFERE WITH THE MANDATE NOR DO ANYTHING INCONSISTENT THEREWITH, AND THEREFORE DID NOT ERR IN DENYING APPELLANTS' MOTIONS.

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1. Pursuant to the Mandate of the Court of Appeals, the District Court Properly Denied Appellants' Motions.

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At the 1966 hearings, the District Court denied the subject motions, and spread the mandate of this Court upon its files and records, although it allowed the appellants to remain on bail, despite the direction of this Court that the appellants be remanded to custody forthwith. United States v. Marchese, 341 F.2d at 801.

It is well settled that once a decision is finally rendered on appeal, the District Court must strictly follow the mandate of the appellate court and may not grant any relief inconsistent therewith.

Clark v. Travelers Indemnity Co., 328 F.2d 819

(7th Cir. 1964);





Paull v. Archer-Daniels-Midland Co.,

313 F.2d 612 (8th Cir. 1963);

Bailey v. Henslee, 309 F.2d 840 (8th Cir. 1962);

Hartman v. Lauchli, 304 F.2d 431 (8th Cir. 1962);

See: In re Sanford Fork & Tool Co., 160 U.S. 247, 255,

16 S.Ct. 291, 40 L.Ed. 414 (1897).

As stated in the Paull case, *supra*, quoting from Thornton

v. Carver, 109 F.2d 316 (8th Cir. 1940):

" 'When a case has been decided by this court on appeal and remanded to the District Court, every question which was before this court and disposed of by its decree is finally settled and determined. The District Court is bound by the decree and must carry it into execution according to the mandate. It cannot alter it, examine it except for purposes of execution, or give any further relief or review it for apparent error with respect to any question decided on appeal and can only enter a judgment or decree in strict compliance with the opinion and mandate.' " 313 F.2d at 617 (Emphasis added).

Doubtless this Court could have remanded the cause to the District Court for further proceedings, but it did not. Rather, it reversed the judgments and remanded the appellants to custody -- absolutely, unequivocally and finally, as is within its power under Title 28, U.S.C. §2106.



It may be noted that appellants supported their motions to file amended findings, conclusions and judgments by quoting from the opinion in United States v. Marchese, supra, wherein it was said:

"We can only conclude the findings are not sufficiently clear to permit us to properly evaluate them, and if for no other reason than this, we would be required to reverse judgment and remand for further findings and conclusions." 341 F.2d at 795.

The above quotation was set forth at page 2 of "Appendix A", annexed to each of appellants' aforementioned motions [C. T. 143, 146, 253, 256]. Certainly the language quoted above means nothing more nor less than what it says, which is simply that if Marchese's petition for writ of habeas corpus, and Del Bono's petition to vacate sentence, had possessed any merit, which they did not, the judgments discharging them from custody would nevertheless require reversal because they were not supported by adequate findings and conclusions as required by Rule 52, Federal Rules of Civil Procedure.

Of all the grounds raised in Marchese's petition for writ of habeas corpus, and Del Bono's petition to vacate sentence, this Court found only one which warranted any consideration by it, and that was whether the Assistant United States Attorney who originally tried the case had suppressed evidence, or knowingly permitted a Government witness to lie on the stand. United States





v. Marchese, supra, 341 F.2d at 789-790. It held that the District Court's finding with respect to this issue was totally unsupported by the evidence adduced in support thereof. United States v. Marchese, 341 F.2d at 801.

On the basis of what has been said, it is submitted that the District Court was limited to doing one, and only one, thing, in order to comply with the mandate of this Court, and that was to spread the mandate, as it did in the instant case.

At this juncture, the Court's attention is respectfully directed to points II through VIII of the argument in appellants' Opening Brief, each of which will be analyzed in succeeding pages.

2. Section 2255, Title 28 U.S.C., Cannot Take the Place of An Original Appeal.

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Appellants allege as the second point of their Argument that they "had the right to raise a substantial constitutional question, even though said question could have been or was litigated on previous proceedings, including the appeal from the judgment of conviction" (Opening Brief, p. 23).

This point was conclusively answered in the opinion in United States v. Marchese, supra, wherein the Court said:

"Section 2255 cannot take the place of an original appeal. More properly stated, §2255 may not be invoked to relitigate questions which were or should have been raised on a direct appeal from the



judgment of conviction." 341 F.2d at 789.

Furthermore, whatever may be said generally with respect to the right to litigate, in a Section 2255 proceeding, issues which were or should have been raised on appeal, it is clear that where, as in the instant case, the mandate of the Court of Appeals, as embraced in its decision and opinion, expressly holds that the District Court erroneously granted collateral relief based on certain specified grounds, the granting of such relief, in an identical kind of proceeding, on identical grounds, should be condemned as nothing short of a direct contravention of the mandate, and a total disregard of the law of the case as established therein.

As held in the cases cited above, the mandate must be followed to the letter. Furthermore, the District Court is absolutely bound to follow the rules of law announced by this Court in its opinion, under the "law of the case" doctrine, in all subsequent proceedings in the same litigation.

Sibbald v. United States, 12 Pet. 488, 492,

9 L. Ed. 1167 (1838);

Fountainbleau Hotel Corp. v. Crossman,

286 F.2d 926, 928 (5th Cir. 1961);

See: Virginia Electric & Power Co. v. N. L. R. B.,

132 F.2d 390, 392 (4th Cir. 1942).

As applied vis a vis successive proceedings in the same court, "law of the case" is, no doubt, nothing more than a rule of practice; but as between the Court of Appeals and the District Court, it



dictates that the lower court must precisely follow the principles of law announced by the higher. In Fountainbleau Hotel Corp. v. Crossman, supra, the court quoted Moore as follows, 286 F.2d at 928:

"Moore states it: 'When therefore, a federal court enunciates a rule of law to be applied in the case at bar \* \* \* it establishes the law, which other courts owing obedience to it must, and which it itself will, normally apply to the same issues in subsequent proceedings in that case.' 1 Moore, Federal Practice P 0.404 [1]."

Thus the District Court manifestly acted precisely as it must have acted, in denying appellants' motions.

3. Appellants May Not, In a Subsequent Motion Under Section 2255, Relitigate Matters Which Were Determined Adversely to Them On An Appeal From the Granting Of a Previous Section 2255 Motion.
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As the third point of their argument, appellants claim that "Any determination made by the Court on a motion under Section 2255 of Title 28, U.S.C., or Habeas Corpus under Section 2243 of Title 28, U.S.C. is not res judicata, and the same question may be raised on subsequent petitions or motions under said sections, especially where constitutional rights have been invaded."





(Opening Brief, p. 26).

Granted, the doctrine of res judicata, as normally understood in civil actions, does not apply. Apparently appellants take this to mean that the District Court should, at the very least, have treated the subject motions "in the alternative" as "new supplemental motions" and given them a full hearing on the "merits" [C. T. 143, 144, 253, 254]. But it is clear that the District Court is "not required . . . to entertain a second or successive motion for similar relief on behalf of the same prisoner" (28 U. S. C. §2255) where, as here, the questions now raised were raised on previous motions, entertained by the District Court, heard on the merits, relief was in fact granted, and the judgments of the District Court in granting such relief were reversed by the Court of Appeals.

Sanders v. United States, 373 U. S. 1, 15,

83 S. Ct. 1068, 10 L. Ed. 2d 148 (1963);

United States v. Marchese, 341 F. 2d 782, 784-785

(9th Cir. 1965).

4. The District Court Has No "Jurisdiction" or "Power" to Contravene the Mandate of the Court of Appeals Directed to It.
- 

As their fourth point, appellants urge: "The United States District Court, following the opinion and remand by the Circuit Court on the last appeal, had the jurisdiction and power to file



amended findings of fact and conclusions of law, and an amended judgment based thereon, granting to petitioners the relief sought, namely, their full and complete discharge." (Opening Brief, p. 29).

This the District Court had no "power" or "jurisdiction" to do, assuming the amended findings of fact and conclusions of law to which they refer are those they lodged with the subject motions. The content of the amended findings and conclusions was explored in preceding pages, and it was shown that they contain no new matter of any substance.

That being the case, the District Court's signing the amended findings, conclusions, and judgment would have amounted to a repudiation of the mandate of this Court and the law by which further proceedings in the Marchese and Del Bono cases must be governed, as enunciated in the Opinion in United States v. Marchese. It is fundamental that the District Court has no "jurisdiction", "power", or "authority" whatever to contravene the mandate of this Court directed to it, or the law of the case announced in its opinion.

Briggs v. Pennsylvania R. Co., 334 U.S. 304,  
68 S.Ct. 1039, 92 L.Ed. 1403 (1948);

Bankers Life and Casualty Co. v. Bellanca Corp.,  
308 F.2d 757, 759 (7th Cir. 1962);

Federal Home Loan Bank of San Francisco v. Hall,  
225 F.2d 349, 385 (9th Cir. 1955)

(footnote 12);





5. The Decision of This Court, Nullifying in Toto the Judgments of the District Court Granting Appellants Their Discharge From Custody, Is Plain and Unambiguous and Does Not Contemplate Any Further Proceedings Below.
- 

Appellants claim, under Point V, that "[s]ince the opinion and remand by the Circuit Court aforesaid was ambiguous, the District Court should have resolved the ambiguity in favor of the petitioners, and should have granted them the relief of a complete discharge, instead of certifying the cases back to the Circuit Court for clarification as to the District Court's power and jurisdiction to determine the matter." (Opening Brief, p. 36). There is nothing ambiguous about the "remand" of this Court in United States v. Marchese, supra. The decision was simply, "Each judgment is reversed, and appellees ordered remanded to custody forthwith".

At any rate, their contention that the District Court should have granted the relief of a complete discharge is a curious way to resolve the supposed ambiguity. Additionally, it is strange that appellants charge error in the District Court's "certifying" the causes back to this Court for clarification, since it was at the suggestion of counsel for appellant Marchese that Judge Clarke "certified" the matter:



"MR. HOCHMAN: Your Honor, would you consider certifying this question to the Court of Appeals. I think it is an interesting jurisdictional question.

"MR. PARSONS: Yes.

. . .

"THE COURT: [A]fter I spread the mandate, then I will certify the matter." [R. T. 1966, 36].

6. Even if Appellants' Motions Had Been Treated As "New" Or "Supplemental" Motions, the District Court Would Not Have Been Justified In Granting Them.
- 

Appellants next assert, as their sixth point, that "[s]ince res adjudicata does not apply to motions under Section 2255 or Habeas Corpus, the District Court should have treated the motions made by the petitioners after remand in the alternative, as new motions under Sections 2255 and 2243 of Title 28, U.S.C., and granted petitioners full and complete discharge as apparently authorized or permitted by the opinion of the Circuit Court." (Opening Brief, p. 39).

With respect to the instant point, it is hard to say whether appellants are claiming the District Court should have granted relief in spite of this Court's mandate, or because of it. On the one hand, they seem to be saying that the District Court should have granted relief whatever may have been the decision of this



Court concerning prior motions for vacation of sentence; and on the other, that the District Court should do so because this Court gave it authority or permission to do so.

As emphasized in preceding paragraphs, the Court of Appeals certainly did not give authority or permission to the District Court to grant further relief based upon any of the grounds contained in the petitions which secured for appellants their discharge from custody in 1963. In fact, the District Court was told that it should not have done so.

With equal emphasis, it is to be pointed out that the District Court was not free to act without regard to the decision of this Court annulling the granting of prior motions or petitions for relief from the imposition of a criminal sentence. The doctrine of *res judicata* is not at issue. What is at issue is the power and authority of the District Court to deviate from the mandate of the Court of Appeals by granting relief based upon grounds which were previously employed in obtaining relief from a criminal sentence, where such grounds were rejected by this Court in holding that the District Court erred in granting the petitions; and thus ignoring the law of the case.





7.       The District Court Had No "Power"  
          Or "Jurisdiction" to Make New Find-  
          ings of Fact and Conclusions of Law  
          of the Kind Proposed by Appellants.

---

It is claimed by appellants, as point number Seven, that "[i]f the District Court had treated said motions in the alternative as new motions aforesaid, it had the power and jurisdiction to make new findings of fact and conclusions of law and judgment, based upon matters presented at all of the hearings and upon the record of the case especially with respect to the violation of the petitioners' constitutional rights in connection with the use by the Government of the Schmidt transmitter." (Opening Brief, p. 41).

Under this point, it seems that appellants are alleging that which is implicit in point number six: That the District Court had the power and jurisdiction to do what they claim it should have done. As shown by the cases cited herein under the discussion of the fourth point, it had neither the power nor the jurisdiction to grant further relief, in contravention of the mandate directed to it.

8.       This Court's Decision in United  
          States v. Marchese Should Not  
          Be Disturbed.

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Finally, as point number eight, appellants state the following: "That the findings of the District Court originally made were not clearly erroneous, and that this Honorable Court should review and revise its decision with respect to the findings made by the



trial court in the light of long established fundamental principles governing appellate powers and procedure with respect to findings of fact." (Opening Brief, p. 42).

This point might best be denominated an appeal from the Court of Appeals to the Court of Appeals. Suffice it to say that as a rule of appellate practice, whatever has been decided on one appeal will not be departed from upon subsequent appeals in the same case.

Thompson v. Maxwell Land Grant & Railway Co.,

168 U.S. 451, 456, 18 S.Ct. 121,

42 L.Ed. 539 (1897);

New York Life Insurance Co. v. Taylor,

158 F.2d 328, 81 U.S. App. D.C. 331 (1946);

Long Beach Dock & Terminal Co. v. Pacific Dock

& Terminal Co., 98 F.2d 833

(9th Cir. 1938).

But even if that rule were disregarded here (and appellees by no means suggest in any way that it should be), it is difficult to see how a different result could be reached. In United States v. Marchese, the only findings of the lower court which were held to be without evidentiary support were those relating to alleged promises of leniency to the informant Sussman in consideration of his helping the Government; the alleged knowledge by the Assistant United States Attorney who tried the case of such a bargain, or reason to know thereof; and the purported suppression of evidence concerning the alleged bargain. United States v. Marchese,





341 F.2d at 795-801. This Court, in six and one-half pages of its opinion, exhaustively reviewed the record, and concluded that appellees (appellants herein) had sought to prove the promise by nothing more than: (1) a denial by a Federal Bureau of Narcotics Agent that it existed; (2) the admitted hope or expectation of the informant Sussman that he would "probably" receive a lighter sentence for his cooperation; and (3) the trial assistant's well-taken and court-sustained objection to a question which called for a witness's conclusion, to-wit, whether an "agreement" existed between Sussman and the agents. United States v. Marchese, 341 F.2d at 801. This, it was held, was not enough. Finally, as was pointed out in the opinion, nothing was "suppressed" by Government counsel trying the case. 341 F.2d at 801.

D. THE DISTRICT COURT CORRECTLY DECLINED TO ENTERTAIN APPELLANTS' MOTIONS ON THE MERITS, SINCE APPELLANTS, AT THE TIME THE SUBJECT MOTIONS WERE MADE, AND AT ALL TIMES THEREAFTER, WERE NOT "IN CUSTODY".

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This Court, after a hearing on March 2, 1965, ordered appellants' bail reinstated [C. T. 140]. Thereafter, Judge Clarke, at the subsequent hearings in the District Court, ordered that they remain on the same bonds pending the instant appeal [R. T. 1966, 30, 43-44; Order Nunc Pro Tunc, entered April 26, 1966].



The rule is that one is not "in custody", so as to confer upon the court jurisdiction to entertain a motion to vacate sentence under Section 2255, or a petition for a writ of habeas corpus, where he is on bail.

Matysek v. United States, 339 F.2d 389

(9th Cir. 1964);

See: Heflin v. United States, 358 U.S. 415,

79 S.Ct. 451, 3 L.Ed.2d 407 (1959);

Johnson v. Hoy, 227 U.S. 245, 248,

33 S.Ct. 240, 57 L.Ed. 497, 499 (1913).

That being the case, the District Court was plainly without power to grant appellants' motions, or to grant any of the relief prayed for therein. Thus it was limited to denying the motions without approaching the "merits" of the amended findings of fact and conclusions of law which appellants sought to file, or the "merits" of the subject motions if treated as "new, supplemental motions". That it in fact denied the motions "not on the merits" is evidenced by the following recital in the Order Nunc Pro Nunc entered April 26, 1966:

" . . . [T]he Court held that the decision and order of the Court of Appeals was ambiguous . . . and that the Court was uncertain as to its power . . . , and on that basis, . . . [denied] the motions . . . ." [C. T. 207, 208].



## CONCLUSION

Appellees' position may be thus summarized:

1. The amended findings of fact which appellants have sought to file contain nothing of substance new or different from those signed by the District Court in 1963, in support of judgments thereafter reversed in United States v. Marchese, 341 F.2d 782 (9th Cir. 1965).
2. The amended conclusions of law present no legal issues which were not raised in Marchese's 1961 petition for a writ of habeas corpus, all of which were before this Court and held in United States v. Marchese to be legally insufficient particularly where they had been ruled upon adversely in prior proceedings.
3. The Court of Appeals, in United States v. Marchese, did not remand the cause for further proceedings; rather, it held that appellants [appellees therein] should have received no relief at all.
4. Since this Court held that the District Court should not have granted any relief to appellants upon the facts before it, its doing so upon no new grounds, with no new facts to support its judgments, would constitute a total repudiation of the mandate directed to it.
5. Once a decision is finally rendered on appeal, the District Court must strictly follow the mandate, and may not grant any relief inconsistent therewith.
6. The District Court is bound to follow the law of the





case, as announced in an opinion of the Court of Appeals, in all subsequent stages of the same litigation.

7. The District Court is not required to entertain a subsequent Section 2255 motion or petition for writ of habeas corpus where all grounds pleaded therein were raised on previous motions or petitions, heard on the merits, and judgments were entered on the merits.

8. The District Court has no jurisdiction, power, or authority to depart from the mandate of the Court of Appeals.

9. As a rule of appellate practice, this Court ought not to hold contrary to its prior rulings in the same case, and there is nothing to indicate that there should be a departure from that doctrine here, the entirety of the files and records herein clearly demonstrating that the decision in United States v. Marchese was right.

10. The District Court was without jurisdiction to grant any Section 2255 or habeas corpus type of relief, since appellants were at all times herein relevant on bail and thus not "in custody" for the purpose of granting such varieties of relief.

Respectfully submitted,

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## CERTIFICATE

I certify that in connection with the preparation of this brief, I have examined Rules 18 and 19 of the United States Court of Appeals for the Ninth Circuit, and that, in my opinion, the foregoing brief is in full compliance with those rules.

/s/ Thomas H. Coleman

THOMAS H. COLEMAN





NO. 20893

# United States Court of Appeals

NINTH CIRCUIT

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MICHELE MARCHESE,

Petitioner-Appellant,

VS.

UNITED STATES OF AMERICA,

Respondent-Appellee.

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JESSE DEL BONO,

Petitioner-Appellant,

VS.

UNITED STATES OF AMERICA,

Respondent-Appellee.

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## APPELLANTS' REBUTTAL BRIEF

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**FILED**

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NO. 2 0 8 9 3

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MICHELE MARCHESE,

Petitioner-Appellant,

vs.

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---

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---

APPELLANTS' REBUTTAL BRIEF

---





We have thoroughly discussed appellants' views and contentions in our Opening Brief. The discussion set forth therein fully and effectively refutes the argument of appellee, so we shall not endeavor in this brief to reiterate much of our argument contained therein, but will from time to time refer to said brief, using the initials "O.B." However, even at the risk of some repetition, we shall briefly rebut some of the points raised by appellee in its Reply Brief, and correct some of the statements made therein. In so doing we shall reply to such appellee's statements, contentions, and arguments as we deem necessary in the order that they appear in its brief, using appellee's numbering of its headings, and referring to said brief as "R.B."

## I

[R.B. p. 1]

On page 2, R.B., appellee stated that the motions of appellants were denied. Actually they were "denied without prejudice pending further clarification by the Circuit Court of Appeals of its opinion and decision." (Clerk's Transcript [referred to herein as C.T.] p. 209) The District Court did not deny the motions of appellants as new or supplemental



motions, but reserved its "determination of such questions following further clarification of its decision, opinion and mandate by the Circuit Court." (C.T. p. 209) It is elemental that a formal order or judgment made by a court is the only order to be considered, and that remarks of the trial judge at the hearing do not stand as against a formal written order made and signed by him.

We further take issue with appellee's statement that the District Court had no jurisdiction to entertain such motions.

### III

[R.B. p. 6]

On page 12, R.B., appellee again makes the statement that Judge Clarke denied the motion. We refer to our correction of said statement, *supra*.

### IV

[R.B. p. 17]

Contrary to appellee's contention, we submit that, construing the opinion of the Circuit Court as a whole, there was definitely an intention that the District Court should have further proceedings to correct deficiencies



in its findings and conclusions and in the relief afforded appellants. (See discussion O.B. pp. 29-39)

The statement of appellee that the instant appeal represents an improper attempt to relitigate issues conclusively laid to rest, is without foundation and has been refuted in our Opening Brief, and will be discussed *infra* in this brief.

V

[R.B. p. 18]

The proposed Amended Finding I (R.B. p. 20) was submitted to Judge Clarke because the Circuit Court had determined and found as a fact itself that no promise of leniency or of a lighter sentence was made to Sussman. Judge Clarke was bound by such finding of this Court even though he disagreed with it. In our Opening Brief (pp. 42-50) and in the Petition for Rehearing on this Court's decision, we pointed out that this Court disregarded its long established rules of appellate review in overturning Judge Clarke's finding. We also suggested that this Court may now review and revise its previous decision. (O.B. pp. 42-44)

With respect to Marchese's Amended Finding XII and





Del Bono's XI (R.B. p. 23), we submit that it follows the rules laid down in *Sanders v. United States*, 373 U.S. 1, and is in accordance with the mandate of the Supreme Court in *Marchese v. United States*, 374 U.S. 101.

Appellee attacks Amended Finding IX and Conclusion IV on the ground that Marchese had no right to object to the search of Del Bono's automobile without a search warrant, under the case of *Jones v. United States*, 362 U.S. 257. Both Marchese and Del Bono were "aggrieved parties," since the evidence was used against them. Furthermore, the federal agents had ample time to obtain search warrants, because if Sussman's statements were to be believed, they must have known beforehand what was going to be done with the Dodge automobile of Del Bono. They also had ample time to obtain arrest warrants of the defendants, but neglected to do so. This failure was held fatal to the prosecution in *Chapman v. United States*, 365 U.S. 610, 5 L. Ed. 2d 828, 81 S. Ct. 776; *Taylor v. United States*, 286 U. S. 1; *Johnson v. United States*, 333 U.S. 10; and *Lustig v. United States*, 338 U.S. 74.

Appellee attacks Amended Conclusion V (R.B. p. 27), which states that by reason of the time served by appellants



and their good prison records, it would be "fair, just and equitable and serve the ends of justice to vacate and set aside the judgment of conviction and discharge petitioners." Appellee states that such ground is not a basis for collateral relief under this Court's decision. Appellee misses the point of such conclusion. It has been repeatedly held that 2255 motions and habeas corpus proceedings are equitable in nature, and the court may consider all the equities of the case in arriving at its decision. While it may be asserted that service of a considerable time in prison and good prison records of appellants do not furnish a basis for a collateral attack on the judgment, the court may, in determining what relief may be granted in a successful attack thereon, take into consideration the good prison records as one factor in order to do what equity and justice might require. The courts did thus in the cases of *McKenna v. Ellis*, 280 F. 2d 593; *Powell v. Hunter*, 172 F. 2d 330; *Hurley v. Reed*, 288 F. 2d 884; and *Powell v. Wiman*, 287 F. 2d 275. (See also O.B. pp. 50-53)

In its Reply Brief (pp. 27-33) appellee asserts that the issue with respect to the use of the Schmidt transmitter was disposed of by this Court's decision, and that appellants are precluded from raising the issue, because it was raised





and passed upon in previous appeals. We have discussed this at length in our Opening Brief (pp. 14-21) and have pointed out that under the case of *Lopez v. United States*, 373 U.S. 426, decided just two weeks before the Supreme Court's decision in *Marchese v. United States*, 304 F. 2d 154 (May 31, 1962), the Supreme Court impliedly overruled the case of *On Lee v. United States*, 343 U.S. 747, thus making the use of the hidden transmitting device a violation of a defendant's constitutional rights under the Fourth and Fifth Amendments. Under the *Sanders* case, *supra*, this violation could be considered regardless of previous rulings and decisions.

This Court, in the last appeal - as in two previous appeals, has avoided a direct ruling on the issue as to whether the use of an electronic device was a violation of Marchese's constitutional rights. In appellants' appeal from the judgment of conviction, the point was first raised that the use of radio equipment was forbidden by Section 605, Title 47, U. S. Code. No mention was then made in Appellants' Opening Brief that the defendants' constitutional rights were violated by such use. In a supplemental brief the point was raised. This Court affirmed the judgment of conviction without opinion, so



nothing could be ascertained as to the grounds of affirmation. Certiorari was thereafter denied by the Supreme Court. However, denial of certiorari by the Supreme Court carries with it no implication whatever of the Court's view on the merits of a case which it has declined to hear. (*Maryland v. Baltimore*, 338 U.S. 912, 919; *United States v. Carver*, 260 U.S. 482, 490; *Sunal v. Large*, 332 U.S. 174, 181)

In dismissing Marchese's petition for habeas corpus on June 29, 1961, Judge Pierson Hall did not pass on the merits of the petition, but stated that the issues presented had been "passed and repassed upon by the trial court. In view of the foregoing this Court lacks jurisdiction to entertain the Writ (*Jones v. Squire* (9th Cir. 1952) 195 F. 2d 179), and accordingly the Petition for the Writ is denied and it is ordered dismissed."

This Court, on May 31, 1962, affirmed said order (304 F. 2d 154), citing *Sunal v. Large*, 332 U.S. 174, and stated:

"Petitioner, having failed to appeal from the denial of his motion under Section 2255, may not now question either the ruling on that motion, or the validity of his sentence, by use of habeas corpus."

The Court completely overlooked the exception set forth in *Sunal*, as well as in other Supreme Court decisions,(O.B.





pp. 23-25) namely, that the rule contended for *does not apply where constitutional rights are invaded*. Its error in holding to such rule was established when the Supreme Court granted certiorari and reversed and remanded the case to the District Court for further proceedings. The District Court followed such mandate, had a hearing and, among other issues raised, held that the use of the electronic transmitter was a violation of the defendants' constitutional rights.

On appeal, this Court again avoided rendering an opinion as to whether or not the use of the device was a violation of defendants' constitutional rights. Instead, it reverted to the same holding that the Supreme Court had previously rejected and reversed, to wit, that Section 2255 may not be invoked to relitigate questions which were or should have been raised on a direct appeal from the judgment of conviction. We submit that this was a direct variance from and contrary to the mandate of the Supreme Court, which had before it all the facts and issues raised by petitioner.

In the case of *Sanders v. United States, supra*, 373 U.S. 1, to which the order in the *Marchese* case referred, the Supreme Court reversed this Court. In that





case, also, there was no appeal from the judgment and no appeal from the denial of the first motion under Section 2255, yet the Supreme Court granted certiorari and rejected the aforesaid rule asserted by this Court in its opinion. Such rule does not apply to violation of constitutional rights, as was so aptly stated by Mr. Justice Black in his dissenting opinion in the case of *Hodges v. United States*, 368 U.S. 235.

We submit that this Court should review and revise its opinion, especially as to such issue, as it has the power and authority to do. (See discussion O.B. pp. 42-44) We especially urge this, since at no stage of the various proceedings, other than the findings and conclusions of Judge Clarke, was there ever a written opinion specifically on whether or not the use of the electronic transmitter was a violation of defendants' constitutional rights.

We pointed out in our Opening Brief (pp. 14-17) how the *On Lee* decision, *supra*, has been breached in subsequent decisions of the Supreme Court, culminating in the *Lopez* case, *supra*, and that now the law appears to be that the use of an electronic transmitting device is a violation of a defendant's constitutional rights under



the Fourth Amendment.

Appellee seeks to apply the language of the majority of the Court with respect to the use of the recording device to the use of an electronic transmitting device, despite the language of the concurring opinion of Mr. Justice Warren and the dissenting opinion of Mr. Justice Harlan, indicating that the majority of the Court felt there was a distinction between the use of a tape recorder to corroborate the Revenue Agent's testimony and a transmitting device. As to the latter, the Court considered the *On Lee* decision, *supra*, as being sapped of all vitality and authority.

There is a further distinction in the *Lopez* case, *supra*, and the instant case. Lopez knew that he was dealing with a federal agent and that whatever he said might be used against him. He, nevertheless, consented to the agent's presence in his office and made the statement recorded. The Court limited the use of the tape to corroboration. In the instant case, Sussman was a friend of Marchese and gained access to Marchese's apartment, not as a known federal agent but on a social and friendly basis without any knowledge on Marchese's part that Sussman was a "special employee" of the Government. His





entry into Marchese's apartment was, therefore, fraudulent and obtained by trickery. Such entry comes within the interdiction of the opinion in *Fraternal Order of Eagles v. United States*, 57 F. 2d 93 (Cert. denied by Supreme Court). In that case federal agents gained access to the lodge by posing as members of a distant branch of the lodge and presented false membership cards. After being admitted they perceived the possession of liquor, then prohibited by law, and on the basis of what they saw and heard they obtained search warrants. It was held that this was a violation of the Fourth Amendment and forbidden, for the reason that entry obtained through fraud, trickery or social acquaintance was, in fact, a trespass. The evidence was therefore suppressed.

Appellee contends (R.B. pp. 33-34) that any decision of the Supreme Court holding that the use of a transmitting device which would violate constitutional rights, would not be applied retroactively. The cases cited have nothing to do with unlawful searches and seizures prohibited by the Fourth Amendment and always enforced against federal officers but deal with new prohibitions imposed on the states through the Fourteenth Amendment. (*Mapp v. Ohio*, 367 U.S. 343) At any rate, Marchese has always raised the issue of unlawful search and was finally permitted to have an adjudication on



that issue by virtue of the Supreme Court's remand in the *Marchese* case, *supra*, on the authority of *Sanders v. United States*, *supra*.

B

[R.B. pp. 34-35]

Appellee asserts that the treatment of the motions as new or alternative motions would constitute an attempt to relitigate matters determined adversely by this Court. As we pointed out (O.B. pp. 26-29), the doctrine of *res judicata* does not apply to 2255 motions or habeas corpus. Moreover, in the *Sanders* case, *supra*, the Court held (p. 15) that controlling weight may be given to a denial of a prior application of habeas corpus only if "(2) the prior determination was made on the merits, and (3) the ends of justice would not be served by reaching the merits of the prior application. Even if the same ground was rejected on the merits, on a prior application, it is open to the applicant to show that the ends of justice would be served by the redetermination of the ground."

In the instant case Judge Clarke found at the 1963 hearing following remand by the Supreme Court that the ends of justice would be served by granting the motions





or petitions, and undoubtedly he would so find again. Such findings are also included in the proposed amended findings and conclusions. Furthermore, we submit that on the issue of the violation of the constitutional rights, there has never been an opinion on the merits, as we have pointed out *supra* and in our Opening Brief.

C. - 1

[R.B. pp. 35-38]

Appellee declares that the District Court was required to follow this Court's mandate and that the District Court properly denied appellants' motions. This denial was without prejudice to the renewal of such motions pending clarification of the ambiguity in this Court's opinion, which governs the construction of the mandate.

The cases cited by appellee are civil cases covering judgments between civil litigants, except the case of *Bailey v. Henslee*, 308 F. 2d 840. In that case the mandate reversing the District Court expressly directed the District Court to grant habeas corpus unless the State should retry petitioner within nine months from the mandate. The question was when did the nine months period commence to run, and this question had to be





answered by the Circuit Court on the second appeal. It is noteworthy that in that case the matter went twice to the Supreme Court of Arkansas, twice to the United States District Court, twice to the Circuit Court, and four times to the Supreme Court, before it reached the Circuit Court in the final determination cited above.

In the cited case of *In re Sanford Fork & Tool Co.*, 160 U.S. 247, the Supreme Court stated with respect to its mandate (page 256):

"But the Circuit Court may consider and decide any matters left open by the mandate of this court, and its decision of such matters can be reviewed by a new appeal only. The opinion delivered by this court at the time of rendering its decree may be consulted to ascertain what was intended by its mandate, and either upon an application for a writ of mandamus or upon a new appeal, it is for this court to construe its own mandate, and act accordingly."

We submit that the above statement is applicable to the instant case, because the opinion and mandate of the Court require them to be construed. We further contend that this Court left open certain matters which could be determined by the District Court at a hearing.



[R.B. pp. 38-40]

Appellee contends that the Circuit Court's ruling that Section 2255 cannot take the place of an original appeal, or to relitigate questions which were or should have been raised on a direct appeal from the judgment of conviction, is the "law of the case." We have already pointed out that the rule of *res judicata* does not apply to 2255 motions or to habeas corpus and that the Supreme Court has granted certiorari on grounds determined previously against petitioners on appeal or denial of habeas corpus or 2255 motions.

The "law of the case" is a rule of practice almost exclusively applied to decisions between civil litigants. In the cited case of *Fountainbleau Hotel etc. v. Crossman*, 286 F. 2d 926 (a civil case), the court made a distinction between the rule of *res judicata* and the "law of the case," stating at page 199:

"And although the latter [*res judicata*] is a uniform rule, the 'law of the case' is only a discretionary rule of practice. It is not controlling here."

In the case of *Southern Ry. Co. v. Cleft*, 260 U.S. 316 (a civil case), in rejecting the application of the





application of the "law of the case" doctrine, the court stated at page 319:

"The prior ruling may have been followed as the law of the case, but there is a difference between such adherence and *res judicata*; one directs discretion, the other supersedes it and compels judgment."

In the cited case of *Virginia Electric & Power v. N.L.R.B.*, 132 F. 2d 390, the court stated that the law of the case did not preclude it from varying from its former decision in view of subsequent decisions of the Supreme Court. Its duty was to decide according to the present situation and not to that existing at the time of the former appeal.

4. - 7

[R.B. pp. 41-45]

The cases cited by appellee under this heading are inapposite, since in those cases (being civil cases) the mandates were explicit as to the judgments to be entered by the trial court. In the instant case there was no clear and explicit mandate for the District Court to follow. We submit that (See O.B.) the District Court had full jurisdiction, power and authority to grant the motion of appellants.



[R.B. pp. 46-48]

In the above point, appellee cites only civil cases involving the determination of rights between civil litigants. We submit that in criminal cases or quasi-criminal cases involving the liberty of petitioners as in 2255 motions or habeas corpus, different rules are applicable. The only issue is, not as to rights existing between litigants, but whether or not petitioner shall be discharged from custody or remanded to and detained in prison. If there has been a change in the law affecting petitioners' rights in petitioner's favor, previous rulings on the theory of the "law of the case" have no part, and such rule should not be applied to petitioner's case any more than the rule of *res judicata*. In fact, the latter rule is much more compelling and, yet, as it has been repeatedly held, such rule is not applicable to 2255 motions or habeas corpus.

D

[R.B. pp. 48-49]

The last point raised by appellee is that, since appellants were not in custody, the District Court had no jurisdiction to entertain motions under Section 2255. If the Court had denied the motions of appellants to file



amended findings, conclusions and judgment, absolutely, and had remanded appellants to custody forthwith, it could entertain the motions as new and alternative motions under Section 2255. However, the District Court denied, without prejudice, the motions to file such amended findings etc. pending clarification by this Court of its mandate, and permitted, pending an appeal, the appellants to remain on bond. The District Court, therefore, reserved its ruling on said motions as new or alternative motions under Section 2255 until after such clarification, to determine what action may be necessary in connection therewith.

We submit that the Circuit Court should authorize the filing of the amended findings, conclusions and judgment discharging appellants, thereby terminating the matter. If this Court should determine otherwise, adversely to appellants, then on remand of them to custody, the District Court may then consider the motions as new or alternative motions under Section 2255 or Section 2243 for habeas corpus.





## CONCLUSION

In conclusion, we respectfully submit that the mandate of the Supreme Court in *Marchese v. United States*, *supra*, 374 U.S. 101, requiring the District Court to reconsider in the light of *Sanders v. United States*, *supra*, 373 U.S. 1, should be followed by this Court, and that the finding that appellants' constitutional rights have been violated, even if in one instance only, as for example in the use of the Schmidt transmitter, should be sustained. Furthermore, the District Court's finding and conclusion that it would be fair, just and equitable and in the ends of justice that appellants' motions be granted and that they be discharged, being within the jurisdiction, purview and discretion of the District Court, should also be upheld. Thus the amended judgment discharging appellants absolutely, and not merely for time served, should be authorized or directed by this Court.

Respectfully submitted,

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## CERTIFICATE OF COUNSEL

I certify that in connection with the preparation of this brief, I have examined Rules 18 and 19 of the United States Court of Appeals for the Ninth Circuit, and that, in my opinion, the foregoing brief is in full compliance with those rules.

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**In the United States Court of Appeals  
for the Ninth Circuit**

**NATIONAL LABOR RELATIONS BOARD, PETITIONER**

*v.*

**HONOLULU STAR BULLETIN, INC., AND ADVERTISER  
PUBLISHING Co., LTD., d/b/a HAWAII NEWSPAPER  
OPERATORS, RESPONDENT**

Enforcement  
the National  
Board

**On Petition for Enforcement of an Order of the  
National Labor Relations Board**

**BRIEF FOR THE NATIONAL LABOR RELATIONS  
BOARD**

ENT

**ARNOLD ORDMAN,**  
*General Counsel,*

**DOMINICK L. MANOLI,**  
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**MARCEL MALLET-PREVOST,**  
*Assistant General Counsel,*

**FILED**

**AUG 5 1966**

**GEORGE B. DRIESEN,  
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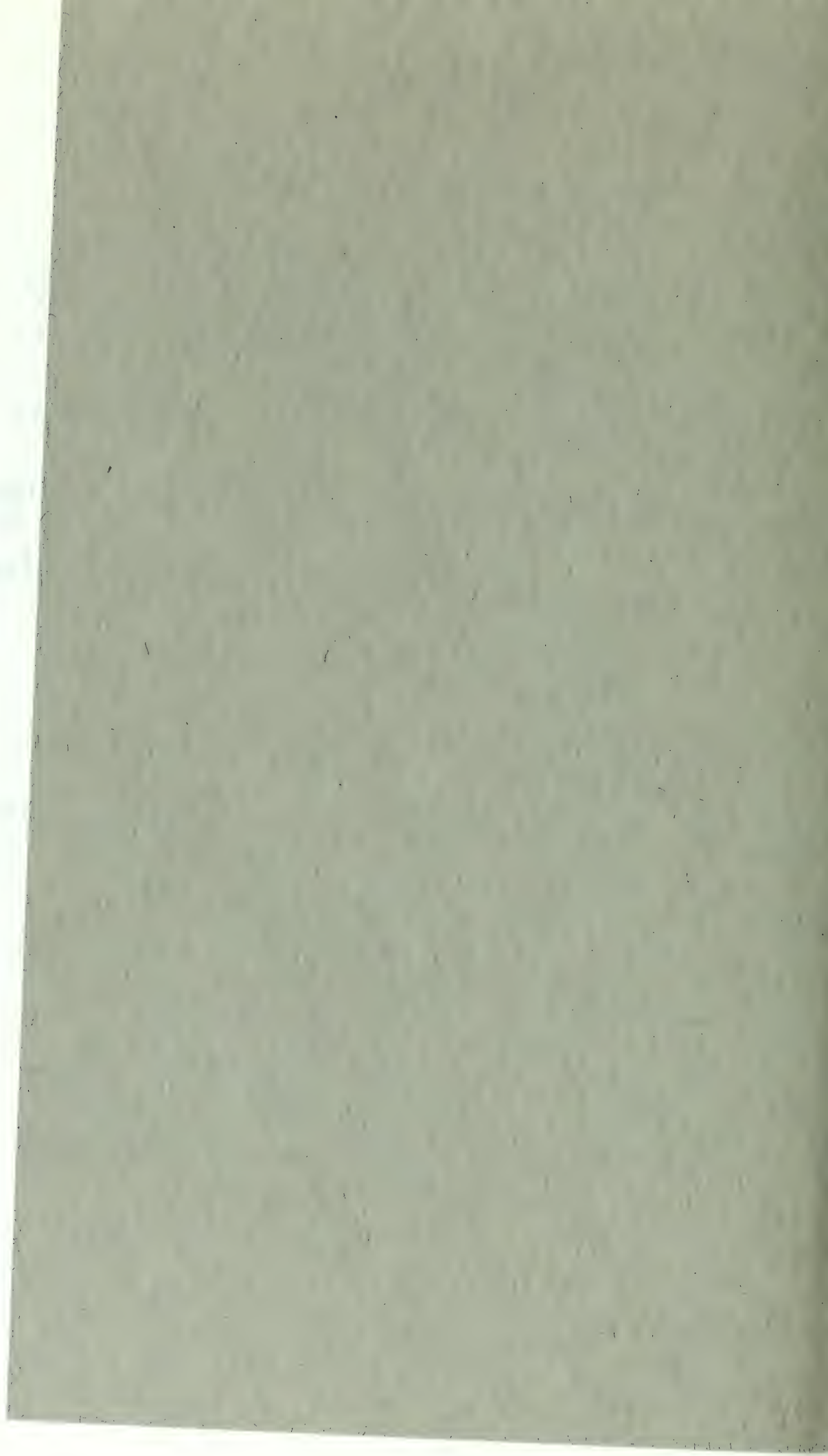
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In the United States Court of Appeals  
for the Ninth Circuit

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No. 20894

NATIONAL LABOR RELATIONS BOARD, PETITIONER

v.

HONOLULU STAR BULLETIN, INC., AND ADVERTISER  
PUBLISHING CO., LTD., d/b/a HAWAII NEWSPAPER  
OPERATORS, RESPONDENT

Enforcement  
of the National  
Labor Board

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On Petition for Enforcement of an Order of the  
National Labor Relations Board

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BRIEF FOR THE NATIONAL LABOR RELATIONS  
BOARD

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JURISDICTION

This case is before the Court upon the petition of the National Labor Relations Board, pursuant to Section 10(e) of the National Labor Relations Act, as amended (61 Stat. 136, 73 Stat. 519, 29 U.S.C., Sec. 151, *et seq.*),<sup>1</sup> for enforcement of its order (R. 11-

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<sup>1</sup> The pertinent statutory provisions are reprinted in the Appendix, *infra*, pp. 38-43.

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25, 30-31)<sup>2</sup> issued on June 29, 1965, against respondent. The Board's decision and order are reported at 153 NLRB No. 83. This Court has jurisdiction of the proceedings, the unfair labor practices having occurred within this judicial circuit. No jurisdictional issue is presented.

## STATEMENT OF THE CASE

### I. The Board's Findings of Fact

The Board found that the Company failed to bargain in good faith with the Union<sup>3</sup> in violation of Section 8(a)(5) and (1) of the Act. The facts underlying the Board's conclusions follow.

#### A. *Background*

##### 1. *Bonus plans promulgated when Star Bulletin and Advertiser operated as independent entities*

Prior to June 1, 1962, the Honolulu Star Bulletin and Honolulu Advertiser functioned as independent entities. The former was published as an afternoon daily newspaper and the latter as a morning daily (R. 12; Tr. 22-23). Each paper separately negotiated

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<sup>2</sup> References designated "R." are to Volume I of the record as reproduced pursuant to Rule 10 of this Court. References designated "Tr." are to the reporter's transcript of the testimony as reproduced in Volume II of the record. References designated "G.C. Exh." or "Resp. Exh." are to exhibits of the General Counsel and respondent, respectively. Whenever in a series of references a semicolon appears, those references preceding the semicolon are to the Board's findings; those following are to the supporting evidence.

<sup>3</sup> Hawaii Newspaper Guild, Local 117, AFL-CIO.



a series of collective bargaining agreements with the Union covering, *inter alia*, the advertising department employees of each paper (R. 13; Res. Exhs. 1, 4). With respect to compensation, the Union's Star-Bulletin and Advertiser contracts had both provided, among other things, for minimum weekly salary schedules. These schedules, however, were coupled with provisions confirming each publisher's right to pay more than the contractual minimums. Neither the Star Bulletin nor Advertiser contract expressly incorporated bonuses into the employees' wage structure (R. 13; Res. Exh 1 (Clause 26, Res. Exh. 4 (Clause 12))). For some years, however, the advertising department personnel of both newspapers were paid substantial incentive bonuses. These payments were made pursuant to numerous plans instituted by management. Thus, from 1957 to June 1962, the Advertiser had continuously maintained in effect a so-called "quarterly" bonus plan which accounted for a significant portion of the regular compensation received by its advertising salesmen.<sup>4</sup> Throughout this same period, Star Bulletin salesmen received comparable bonuses pursuant to a series of plans promulgated for specific business purposes. Each plan was discontinued when management considered the plan's purpose had been achieved (R. 13; Tr. 20, 24, 32-33, 35-37, 67-69, 93-95, 102).

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<sup>4</sup> Union President Roy Kruse testified without contradiction that the Advertiser's quarterly bonus plan generally accounted for 10 percent of the salesmen's monthly wages (Tr. 24).

## 2. *The Star Bulletin and Advertiser consolidation*

Effective June 1, 1962, the Star Bulletin and Advertiser combined their production facilities and formed a new legal entity—the Hawaii Newspaper Operators (HNO)<sup>5</sup>—for the purpose of publishing, printing, circulating, and selling both newspapers.<sup>6</sup> The newly combined operation was directed by the Hawaii Newspaper Agency, a business entity comprised of three managerial employees (R. 13; Tr. 22-23, 111-112).

When the consolidation occurred, the Star Bulletin and Advertiser had separate contracts in effect with the Union which were both due to terminate on March 31, 1963. To resolve any controversies which might arise prior to the negotiation of a new contract for the combined operation, the Company and the Union entered into an “interim” agreement on July 13, 1962, governing the conditions of employment, *inter alia*, of the Company’s 40-50 advertising department workers. Essentially, the agreement provided that the provisions of the existing Star Bulletin contract would be “deemed incorporated into a separate agreement” to be “continued in full force and effect,” presumably for the remainder of the contract’s stated term (R. 13; Tr. 93-95, 97, 14; Resp. Exhs. 3, 4). According to the undisputed testimony of Assistant

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<sup>5</sup> Hereafter referred to as the Company or Respondent.

<sup>6</sup> HNO continued to publish the Advertiser as a morning newspaper and the Star Bulletin as an evening paper. Additionally, a joint Sunday morning publication was printed (R. 13; Tr. 22-23).



General Manager Brandt, there was no discussion relating to bonus payments in the negotiation sessions which produced the "interim" agreement (R. 19; Tr. 106).

In the meantime, immediately after the June 1 consolidation, the Company discontinued the longstanding "quarterly" bonus plan which had been in effect at Advertiser and the so-called "Sunday bonus plan" which Star Bulletin had previously promulgated for its advertising salesmen. To allay the employees' fears that bonuses would no longer be granted, the Company posted and distributed notices promising that it would reinstitute incentive bonus plans which would yield sums of money comparable to the amounts received under the prior plans (R. 14; Tr. 28, 37-38).

On September 19, 1962, Carl Barrea, respondent's advertising sales director, promulgated a Saturday-Monday bonus plan whereby the employees would receive payment for advertising lineage sold for the Saturday Star Bulletin, Monday Advertiser, or both. Union President Kruse thereafter protested to retail advertising manager Nelson at the weekly meetings of his department that this plan was not yielding adequate bonuses and that it should have been made retroactive to June 1, 1962. Subsequently, in February 1963, the Company promulgated "Proposed Bonus Plan #1". Pursuant to that plan, the advertising salesmen were divided into two teams which were declared eligible to receive monthly payments whenever their total "lineage performance" surpassed a specified quota. The employees were apprised that the purpose of this plan was to stimulate the Company's sales

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effort and further that it "may be revised or discontinued at any time even though the present objective is to make this effective for the first 4 months of 1963" (Resp. Exh 2). After the plans became operative, the Company paid bonuses in the form of supplementary weekly or monthly paychecks. Employee Kruse estimated that as a result of the two mentioned plans he received bonuses which on the average totaled 5-7 percent of his entire earnings<sup>7</sup> (R. 14; Tr. 11-14, 31-33, G.C. Exh. 3; Resp. Exh. 2).

Under the terms of the "interim agreement" the Company's contract with the Union terminated on March 31, 1963. Initial negotiations for a new contract were unsuccessful, and the Union called a strike on June 22, 1963. It lasted until August 2 (R. 15; Tr. 108). Three days later, on August 5, the Company notified its advertising staff in a memorandum from Mr. Nelson that it had discontinued both the "Saturday-Monday" and "monthly team" bonus plans. The memorandum concluded, however, with a promise that "[n]ew plans will be presented as soon as possible" (R. 15; Tr. 15, G.C. Exh. 4). In fact, no new plans were presented. Accordingly, beginning about 1 week after this memorandum was posted, Union President Kruse repeatedly queried Nelson and Barrea during regular morning meetings of the sales staff about the status of new bonus plans. He was advised, in essence, that no new plans had yet been approved

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<sup>7</sup> Kruse also testified without contradiction that for the month of May 1963, he received approximately \$60 in bonus payments pursuant to the two mentioned plans (R. 14; Tr. 14).



by management. During one morning meeting, Nelson suggested that the staff form their own committee to prepare some "ideas" for presentation. Kruse and four other staff members who also belonged to the Union volunteered to serve on that committee. Their efforts culminated in two proposed plans which were presented to management during the September 25 sales meeting. Nelson declared that they looked "pretty good" but would have to be submitted to Frederick Brandt, assistant general manager, for approval. Such approval was not forthcoming, however, and Kruse thereupon queried Barrea and Nelson at least once or twice a week as to the status of the committee proposals. He was advised repeatedly that "nothing had been okayed yet" but that the entire subject of bonus plans was still being studied (R. 15; Tr. 16-18).<sup>8</sup>

### 3. *The Company and Union execute a new contract*

On October 31, 1963, while the bonus question was still in dispute, the Company and Union signed a new contract effective from October 1, 1963, until May 31, 1966, which covered, *inter alia*, all respondent's advertising department employees.<sup>9</sup> Section 12 of the

<sup>8</sup> The Company has conceded that Brandt, Barrea and Nelson are supervisors within the meaning of the Act (R. 9).

<sup>9</sup> Pursuant to the contract, the bargaining unit relevant here was defined as follows (R. 15; G.C. Exh. 2):

All advertising department employees, excluding confidential secretaries, temporary employees, guards, professional employees, employees covered by other collective bargaining agreements, the advertising editor, advertis-

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new contract, dealing with minimum salaries, guaranteed that the Company would not reduce the present salaries of employees covered thereby. The term "present salary" was defined as the straight time weekly salary being paid for a workweek of 40 hours, exclusive of "payments for overtime or bonus or any other extra payments."<sup>10</sup> This provision was a precise replica of a provision in the Union's 1961 contract with the Star Bulletin which, as explained above, was later incorporated into the 1962 "interim agreement" and remained in effect until March 31, 1963 (R. 15-16; G.C. Exh. 2, Sec. 12(a); Res. Exh. 4, Sec. 12(a)).<sup>11</sup> In the negotiations which culminated in Section 12 of the current contract, the parties once again did not discuss bonus plans or the Company's

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ing sales director, retail advertising manager, general advertising manager, classified advertising manager, advertising production manager, assistant retail advertising manager, assistant classified advertising manager, advertising commission salesmen, classified telephone room supervisor, promotion manager and all supervisors as defined by the Act.

<sup>10</sup> The contract did not contain a general managerial prerogative clause as such. Nor did it contain any waiver clause whereby the parties forego their rights to bargain with respect to any subject not covered in the contract.

<sup>11</sup> The Union's 1961 contract with the Advertiser had contained a comparable prohibition against reductions in the present salary of covered workers. However, the only exclusions from the contractual term "present salary" were "payments for overtime or any other extra payments"; unlike the Star Bulletin contract, this provision did not specifically exclude bonuses from those salary payments which management had committed itself to maintain in effect. (R. 16; Res. Exh. 1, Sec 26(B)).

prior practice of promulgating and terminating such plans unilaterally. Nor did the parties discuss the significance, if any, of their adopting the "present salary" provision of the Star Bulletin contract rather than the comparable provision of the Advertiser contract (R. 16, 19; Tr. 15-16, 62, 78-79, 100-101, 105-106).

**B. *The refusal to bargain***

On January 2, 1964, Union President Kruse accompanied by Thomas Lum, the Union's administrative officer, called upon Assistant General Manager Brandt to question the Company's continued failure to establish new bonus plans for the advertising department salesmen. Brandt replied initially that to be feasible the plan would have to include all of the Company's workers, "including the business office staff, janitors and what-not." The Union's spokesmen responded that they sought only the Company's commitment to reinstate bonus plans like those previously available to advertising personnel (R. 16; Tr. 19-20, 79-80). To this request, Brandt responded that (R. 16; Tr. 20):

. . . he didn't feel that the bonus plan was a negotiable item, that he felt that it was his company's prerogative to . . . put them in or take them out whenever they felt like it, and he didn't feel it was part of the wage structure.

Brandt further explained that the contract covered "everything that was negotiable" and that bonuses were therefore not a negotiable item since they were not covered in the contract (R. 16-17; Tr. 79-80).

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On March 17, Brandt again told Kruse and Lum that the subject of bonus plans was not negotiable. Pursuant to the direction of the bargaining unit members, Lum then wrote to Brandt requesting that a date be set to negotiate a new bonus plan with the Union. On or about March 25, Brandt orally advised Lum that his position remained unchanged and that the Union representatives could pursue whatever course of action they desired. The instant unfair labor practice charge was filed 1 week later (R. 17; Tr. 20-21, 25-26, 80-84, G.C. Exh. 1(a)).

## II. The Board's Conclusions and Order

Upon the foregoing facts, the Board found, in agreement with the Trial Examiner, that the Company violated Section 8(a)(5) and (1) of the Act by refusing to bargain in good faith with the Union with respect to the formulation and reinstitution of incentive bonus plans for advertising department employees (R. 30-31).<sup>12</sup> The Board's order requires the Company to cease and desist from refusing to bargain in good faith with the Union, or from in any like or related manner interfering with, restraining or coercing employees in the exercise of their rights guaranteed in Section 7 of the Act. Affirmatively, the order requires the Company to bargain, upon request, with respect to the formulation and reinstitution of incen-

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<sup>12</sup> The Board, however, did not adopt the Trial Examiner's conclusion (R. 21) that respondent refused to bargain about a bonus as of October 1, 1963. The Board found that the refusal to bargain initially occurred on January 2, 1964, and continued thereafter (R. 30).

tive bonus plans for its employees, and to post appropriate notices (R. 23-24).

## ARGUMENT

### I. The Board's Finding That Respondent Refused to Bargain, in Violation of Section 8(a)(5) and (1) of the Act, is Supported by Substantial Evidence on the Record as a Whole

#### A. Introduction

The duty to bargain collectively, as defined in Section 8(a)(5), 8(b)(3) and 8(d) of the Act, requires, *inter alia*, that both parties upon request meet "at reasonable times and confer in good faith with respect to wages, hours, and other terms and conditions of employment . . ." Before the Board, respondent did not contest the fact that its longstanding incentive bonus payments constitute "wages" and thus a mandatory subject of bargaining within the meaning of the Act. See, for example, *Singer Manufacturing Corp. v. N.L.R.B.*, 119 F. 2d 131, 136 (C.A. 7), cert. denied, 313 U.S. 595, enforcing 24 NLRB 444, 459, 460, 470; *N.L.R.B. v. Niles-Bement-Pond Company*, 199 F. 2d 713-714 (C.A. 2), enforcing 97 NLRB 165; *N.L.R.B. v. Electric Steam Radiator Corp.*, 321 F. 2d 733, 737 (C.A. 7), enforcing 136 NLRB 923; *General Telephone Co. v. N.L.R.B.*, 337 F. 2d 452, 453-454 (C.A. 5), enforcing in relevant part, 144 NLRB 311. On January 2, 1964, and March 17, 1964, the Union requested that respondent bargain with it concerning the promulgation of bonus plans and respondent admittedly refused to do so. Respondent asserts,

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nonetheless, that it has not violated the Act; the primary thrust of its defense before the Board was that the Union waived its statutory right to bargain with respect to bonus plans, thereby rendering respondent's conduct lawful.<sup>13</sup> But the Board ruled that a waiver of the statutory right to bargain must clearly and unmistakably be shown to have been consciously yielded, and that no such showing was made on this record. We show first that the Board's doctrine governing waiver of the statutory right to bargain is sound.

#### B. *The Board's waiver doctrine and its rationale*

The Board has consistently taken the position, with court approval, that while a party may waive its right to bargain about terms and conditions of employment such waiver must be conscious, clear, and unmistakable; the waiver of a right so basic and traditional as the statutory right to bargain will not be lightly inferred.<sup>14</sup> See, for example, *Pacific Coast*

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<sup>13</sup> In addition, respondent contended that the Board erred in asserting jurisdiction over the subject matter of this action instead of compelling the Union to exhaust its remedies pursuant to the grievance-arbitration machinery set forth in the collective bargaining agreement between the parties. This contention is discussed *infra*, pp. 28-36.

<sup>14</sup> The aforementioned settled rule limiting waivers of the statutory right to bargain comports with established principles governing waiver of rights conferred by the Act. For example, the Supreme Court held in *N.L.R.B. v. Lion Oil Company*, 352 U.S. 282, 293 "where there has been no express waiver of the right to strike, a waiver of the right during . . . [the contract] period is not to be inferred." *Accord Mastro Plastic Corp. v. N.L.R.B.*, 350 U.S. 270, 283. See also,



*Ass'n of Pulp & Paper Mfrs. v. N.L.R.B.*, 304 F. 2d 760, 763, 765 (C.A. 9); *N.L.R.B. v. Perkins Machine Co.*, 326 F. 2d 488; *Timken Roller Bearing Co. v. N.L.R.B.*, 325 F. 2d 746 (C.A. 6), cert. denied, 376 U.S. 971; *N.L.R.B. v. Otis Elevator Co.*, 208 F. 2d 176, 177, 179 (concurring opinion) (C.A. 2); *N.L.R.B. v. Item Co.*, 220 F. 2d 956 (C.A. 5), cert. denied, 350 U.S. 836; *N.L.R.B. v. Taylor*, 338 F. 2d 1003 (C.A. 5); *N.L.R.B. v. J. H. Allison & Co.*, 165 F. 2d 766, 768 (C.A. 6), cert. denied, 355 U.S. 814. As the Board stated in this case (R. 18), quoting from its earlier decision in *Proctor Manufacturing Co.*, 131 NLRB 1166 at 1169:

The Board's rule, applicable to negotiations during the contract term with respect to a subject which has been discussed in precontract negotiations but which has not been specifically covered in the resulting contract, is that the employer violates Section 8(a) (5) if, during the contract term, he refuses to bargain or takes unilateral action with respect to the particular subject, unless it can be said from an evaluation of the prior negotiations that the matter was "fully discussed" or "consciously explored" and that the Union "consciously yielded" or clearly and unmistakably waived its interest in the matter.

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*N.L.R.B. v. Washington-Oregon Shingle Weavers Ass'n.*, 211 F. 2d 149, 153 (C.A. 9), citing with approval *Tide Water Associated Oil Co.*, 85 NLRB 1096, 1098.

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Accord: *Inland Steel Company*, 77 NLRB 1, 14-15; *TideWater Associated Oil Company*, 85 NLRB 1096, 1098; *International News Service, Div. of the Hearst Corp.*, 113 NLRB 1067, 1070; *Press Company, Inc.*, 121 NLRB 976-980; *Beacon Piece Dyeing and Finishing Co., Inc.*, 121 NLRB 953, 956-961; *Servette, Inc.*, 133 NLRB 132, 136-137; *Toffenetti Restaurant Company, Inc.*, 136 NLRB 1156, 1167-1168; *Adams Dairy Co.*, 147 NLRB 1410, 1412.

The rationale underlying the Boards' strict requirements for waiver has been expressed at length in numerous decisions cited above. First, this rule gives effect to the basic objective of the statute by encouraging the practice and procedure of collective bargaining as a means of eliminating industrial strife. Section 1 of the Act.<sup>15</sup> By requiring bargaining on any bargainable issue which was not expressly resolved in the contract, the Board's rule prevents strikes—authorized or unauthorized—by avoiding the accumulation of resentment, dissatisfaction and frustration which the preclusion of bargaining might well arouse in the employees. Cf. *Pacific Coast Ass'n of Pulp & Paper Mfrs. v. N.L.R.B.*, 304 F. 2d 760, 764 (C.A. 9).<sup>16</sup> That this is a reality of industrial life

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<sup>15</sup> Section 1 provides, in relevant part, "[i]t is hereby declared to be the policy of the United States to eliminate the causes of certain substantial obstructions to the free flow of commerce and to mitigate and eliminate those obstructions when they have occurred by encouraging the practice and procedure of collective bargaining . . . ."

<sup>16</sup> In *Jacobs Manufacturing Co.*, 94 NLRB 1214, 1217-1218, enforced, 196 F. 2d 680 (C.A. 2), the Board observed that to



was long ago confirmed by leading authorities in the field of labor relations.<sup>17</sup> Further, by assuring the parties the right to postpone discussion on matters which are only of contingent significance at the time of negotiation but which may thereafter ripen into prominence, the Board eases the path of parties negotiating agreements.

If waiver of the right to bargain could be inferred where it was not clearly intended, a party would hesitate to raise issues on which agreement might not be obtained lest it be foreclosed from discussing those topics throughout the entire contract period. In the Board's view, such a doctrine, at the very least, would stifle rather than encourage the free exchange of ideas and diminish the mutual trust between the parties which lies at the heart of a successful bargaining relationship. Management would hesitate to initiate discussions on possible innovations in the manufacturing process, fearing that, if agreement is not reached in the negotiations, management would be precluded from later introducing that innovation, no matter how desirable or necessary, because it had "waived" its right to bargain on the matter. See

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"permit a party to a bargaining contract to avoid discussion when it was sought on subject matters not contained in the contract—would serve, at its best, only to dissipate whatever . . . good will . . . has been engendered by the previous bargaining negotiations that led to the execution of a bargaining contract; . . . ."

<sup>17</sup> See, for example, Randle, *Collective Bargaining Principles and Practices* (Houghton Mifflin Co., 1951), pp. 91-92; Hill and Hook, *Management at the Bargaining Table* (McGraw-Hill Book Co., 1945), pp. 283-284.

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*N.L.R.B. v. Katz*, 369 U.S. 736. Unions, on the other hand, would refrain from raising questions on which agreement might not be reached lest they be held to have "bargained away" the right to raise such issues thereafter. This would undoubtedly lessen the likelihood of good faith exploration culminating in an agreement obviating future disputes. In addition, a readiness to infer waiver would be grossly unfair to the employees whose interests in general conditions of employment the union is obliged to represent.

In sum, both parties' freedom in a legitimate area of collective bargaining is protected by the Board's ruling and the rule lessens the need to resort to economic weapons which produce interruptions in the free flow of commerce. Accord: *N.L.R.B. v. J. H. Allison & Co.*, *supra*, 165 F. 2d at 768.<sup>18</sup>

The Board's waiver doctrine also comports with the traditional concept of collective bargaining as a continuous process of which the execution of contracts is only an initial part. This concept has long been recognized by the courts. In *Aeronautical Industrial District Lodge 727 v. Campbell*, 337 U.S. 521, 525,

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<sup>18</sup> There, the Sixth Circuit commented as follows:

Nor do we see logical justification in the view that in entering into a collective bargaining agreement for a new year, even though the contract was silent upon a controverted matter, the union should be held to have waived any rights secured under the Act, including its right to have a say-so as to so-called merit increases. Such interpretation would seem to be disruptive rather than fostering in its effect upon collective bargaining, the national desideratum disclosed in the broad terms of the first section of the National Labor Relations Act.



the Supreme Court stated, "It is of the essence of collective bargaining that it is a continuous process. Neither the conditions to which it addresses itself nor the benefits to be secured by it remain static. They are not frozen even by war." And in *N.L.R.B. v. Newark Morning Ledger*, 120 F. 2d 262, 267 (C.A. 3), cert. denied 314 U.S. 693, the Court said:

Collective bargaining is thus seen to be a continuing and developing process by which, as the law now recognizes, the relationship between employer and employee is to be molded and the terms and conditions of employment progressively modified along lines which are mutually satisfactory to all concerned. It is not a detailed or isolated procedure which, once reflected in a written agreement, becomes a final and permanent result."

Accord: *N.L.R.B. v. J. H. Allison & Co.*, *supra*, 165 F. 2d 766. Indeed, this analysis of the bargaining process was recently reaffirmed by the Supreme Court in *United Steelworkers v. Warrior Navigation Co.*, 363 U.S. 574. The Court observed (at 580):

A collective bargaining agreement is an effort to erect a system of industrial self-government . . . The mature labor agreement may attempt to regulate all aspects of the complicated relationship, from the most crucial to the most minute over an extended period of time. Because of the compulsion to reach agreement and the breadth of the matters covered, as well as the need for a fairly concise and readable instrument, the product of negotiations (the written document) is, in the words of the late Dean Shulman, "a compila-



tion of diverse provisions; some provide objective criteria almost automatically applicable; some provide more or less specific standards which require reason and judgment in their application; *and some do little more than leave problems to future consideration with an expression of hope and good faith.*" Shulman [*Reason, Contract, and Law in Labor Relations*, 68 Harv. L. Rev. 999], *supra*, at 1005 [Emphasis added.]<sup>19</sup>

Thus, a collective agreement does not define all the obligations of the parties or contain everything upon which they have in fact agreed. Consequently, a labor agreement is not like an ordinary private commercial contract. It follows that the general rule of contract law that a party's obligation under a contract is limited to the express terms of the written instrument alone is inapplicable to labor agreements.<sup>20</sup>

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<sup>19</sup> See also, *Local 833, UAW v. N.L.R.B. (Kohler Co.)*, 300 F. 2d 699, 707 (C.A. D.C.), cert. denied, 370 U.S. 911.

<sup>20</sup> Professors Shulman and Chamberlain observed in *Cases on Labor Relations* (The Foundation Press, 1949), at p. 3, that the "heart of the collective agreement—indeed, of collective bargaining—is the process of continuous joint consideration and adjustment of plant problems. And it is this feature which indicates the great difference between the collective labor agreement and commercial contracts generally. The latter are concerned primarily with end results; the former, with continuous process." See also, Millis and Montgomery, *Organized Labor*, Vol. III of the *Economics of Labor* (McGraw-Hill Book Co., 1945), p. 354. Cf. Cox and Dunlop, *The Duty to Bargain Collectively During the Term of an Existing Agreement*, 63 Harv. L. Rev. 1097, 1100, 1119. But see *N.L.R.B. v. Nash-Finch Co.*, 211 F. 2d 622 (C.A. 8).

In recent years, an increasing number of enlightened representatives of both labor and management have recognized that continuous discussions are the best avenues to peaceful and intelligent resolution of the complex problems which have arisen in their respective industries. To that end, the parties have established committees in the steel, automobile, meat-packing, construction and longshore<sup>21</sup> industries, for

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<sup>21</sup> The Report of the National Labor-Management Panel to the Director of the Federal Mediation and Conciliation Service (December 30, 1964) contains the following analysis (p. 4):

The process of exploring and solving problems before they reach crisis stage is not a new concept nor a new practice in labor-management relations. Our advancing technology with its attendant problems has, however, added new impetus to this development.

The most widely publicized examples of such joint ventures are found in the major industries: the Human Relations Committee [See 45 LRRM 207-209] and Kaiser Long Range Committee in the steel industry; the Joint Study Committees in the auto and electrical manufacturing industries; the Armour Plan in the meat packing industry; the West Coast Labor Relations Committee in longshore; and the long-established joint committees in the building and construction industry.

These cooperative efforts were in the main initiated by the parties themselves . . . ."

For further details as to the manner in which the mentioned plans have been implemented, see, for example, Balsley "*The Kaiser Steel-United Steelworkers of America Long Range Sharing Plan*," Sixteenth Annual Proceeding of the Industrial Relations Research Ass'n, pp. 48-58 (1963); Killingsworth *Cooperative Approaches to Problems of Technological Change*, pp. 61-94 in *Adjusting to Technological Change* (Harper & Row, 1963); Horvitz, "*The ILWU—PMA Mechanization and Modernization Agreement: An Experiment in Industrial Relations*," Sixteenth Annual Proceedings of the Industrial Relations Research Ass'n., pp. 22-33 (1963).



example, which meet regularly throughout the entire contract period to explore complex and controversial subjects which were not completely resolved in their earlier agreements. In this manner, the parties endeavor to solve their problems on the basis of comprehensive and thoughtful analysis rather than to reach an indecisive accord purely as a last-minute stopgap measure to avoid a threatened strike at the termination of a contract. The Board's waiver doctrine reflects and supports these aspects of industrial relations by discouraging parties from withdrawing from the bargaining process matters on which agreement has not in fact been reached.

Finally, it is noteworthy that, even apart from the fact that the policies of the Act require a strict waiver rule, the Board and court approach is in accord with the accepted principle as to waivers generally: they will not be "inferred from doubtful or equivocal acts or language." 5 *Williston on Contracts*, p. 240 (3d ed. 1961).

In light of all these considerations, we submit, the Board, as a body of "experienced officials with an adequate appreciation of the complexities of the subject," *Republic Aviation Corp. v. N.L.R.B.*, 324 U.S. 793, 800, has reasonably concluded that waiver of a party's right to bargain about subjects must be clearly and unmistakably proven on the record. We show below that no such showing was made here and that the Board rightly concluded that respondent violated the Act when it admittedly refused to bargain about bonus plans.

C. *The Board properly found that the Union did not waive its right to bargain with respondent concerning the promulgation of a bonus plan*

1. *The contract contains no waiver of the right to bargain*

The contract does not contain any express waiver of the Union's right to bargain about bonuses. As set forth in the Statement, Section 12(a) of the contract provides that "[t]here shall be no reduction in the present salary of any employee covered by this agreement. The term 'present salary' is understood to mean the straight time weekly salary being paid for a work week of forty (40) hours and does not include any payments for overtime or bonus or any other extra payment." (G.C. Exh. 2). Section 12(a), at most, frees the respondent of any contractual obligation to maintain bonuses throughout the contract period (R. 18-19).<sup>22</sup> But the express contractual language does no more; it does not specifically bind the Union thereafter to forego its statutory right to bargain with respect to the promulgation of new plans. Conversely, Section 12(a) does not expressly privilege respondent's re-

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<sup>22</sup> Respondent's unilateral discontinuance of the existing bonus plan in August 1963 was not the basis of the instant unfair labor practice complaint. The only issue presented here is whether respondent violated the Act by subsequently refusing to meet and confer with the Union in January and March 1964 concerning a new plan.

fusal to discuss such new proposals. Nor does it do so implicitly.<sup>23</sup>

First, there is no record evidence that in agreeing to incorporate Section 12(a) in their contract either party stated that the Union was thereby waiving its right to bargain about bonuses. True, this section derived from Section 12 of the Star Bulletin contract

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<sup>23</sup> Whether waiver is shown by pre-contract negotiations or by contract language, it must be shown clearly and unmistakably. As the Sixth Circuit stated in *Timken Roller Bearing Company v. N.L.R.B.*, *supra*, 325 F. 2d 746 at 751:

“ . . . We recognize that the Union could have relinquished this right [to bargain] under the provisions of the bargaining agreement . . . But such a relinquishment must be in ‘clear and unmistakable’ language. *Tide Water Associated Oil Company*, 85 NLRB 1096; *N.L.R.B. v. Item Company*, 220 F. 2d 956, 958-959 (C.A. 5) . . . .”

See also, the opinion of Judge Clark in *N.L.R.B. v. Otis Elevator Co.*, *supra*, 208 F. 2d 176, 178-179.



which the parties had stipulated in their July 13, 1962, agreement would govern the newly formed corporation until March 31, 1963. The comparable section, 26(b), of the prior Advertiser contract did not expressly exclude bonuses from the definition of "salary." But no conscious, clear and unmistakable waiver can be inferred from the contrast between the two agreements. Brandt, respondent's Assistant General Manager, testified that in the negotiations preceding the "interim agreement" the parties never discussed the differences between the two prior agreements (R. 19; Tr. 100-101, Res. Exh. 1, 3). Consequently, the record does not support the view that the parties chose the Star Bulletin contract because it contained a "waiver" provision.

Second, there is no evidence that the Union sought or received or that respondent offered any *quid pro quo* in exchange for the Union's supposed waiver. Furthermore, respondent's argument that, by excluding bonuses from the definition of "salary," the parties agreed that bonuses would be left to the unilateral determination of management is rebutted by the contract itself. In section 10(c) of the contract (G.C. Exh. 2, p. 5) the parties agreed that employees would be compensated for overtime work "at one and one half ( $1\frac{1}{2}$ ) times the basic straight hourly wage." Yet overtime, like bonuses, is one of the matters excluded from the definition of "salary" in section 12 (a). It thus seems plain that such exclusion was not "clearly and unequivocally" viewed by the parties as tantamount to an agreement that matter excluded was left solely to management's determination. In

these circumstances, we submit the Union did not "clearly and unmistakably" waive its right to bargain about bonuses. See, e.g., *Pacific Coast Ass'n of Pulp and Paper Mfgers. v. N.L.R.B.*, *supra*, 304 F. 2d at 763, 765; *General Telephone Company of Florida v. N.L.R.B.*, 337 F. 2d 452, 454 (C.A. 5); *N.L.R.B. v. Gulf Atlantic Warehouse Co.*, *supra*; *N.L.R.B. v. The Item Company*, *supra*; *N.L.R.B. v. Perkins Machine Co.*, *supra*, 326 F. 2d at 489; *N.L.R.B. v. Otis Elevator Company*, *supra*; see also, generally, *N.L.R.B. v. Lion Oil Company*, *supra*, 352 U.S. 282, 293.

2. *The Union did not "clearly and unmistakably" waive its right to bargain by its acquiescence in respondent's prior unilateral changes in bonus plans*

The Union did not waive its right to bargain about bonuses by not objecting to management's unilaterally instituted bonus plan changes. First, waiver of the right to bargain about a matter cannot be implied from acquiescence in an employer's unilateral actions since such a "waiver" is neither "clear" nor "unmistakable." Quite the contrary, it is no more than an acceptance of the substance of what management has done. Indeed, this Court has rejected an argument that waiver of the statutory right to bargain can be implied from a Union's past acquiescence. In *Pacific Coast Ass'n of Pulp & Paper Mfgers. v. N.L.R.B.*, *supra*, 304 F. 2d 760, 764 this Court wrote:

The fact that, for nearly 15 years, the Unions did not insist upon [bargaining about pensions



on an Association-wide level] does not require a finding that they had bound themselves not to do so the next time.

Accord, *General Telephone Company v. N.L.R.B.*, *supra*, 337 F. 2d 452, 454 (C.A. 5). In any event, the Union's failure to raise the bonus issue during negotiations preceding the 1963 contract did not constitute a waiver of its right to bargain about the subject in the future. As the record shows, when respondent discontinued an existing bonus plan on August 5, 1963, it promised that new plans would be presented soon. Similarly, when respondent discontinued existing bonus plans in June 1962, it promised that comparable bonus plans would be reinstituted thereafter. New plans were instituted in September 1962 and February 1963. Consequently, the Union's acquiescence demonstrated no more than its willingness to await respondent's presentation of new plans before deciding what steps, if any, it should take, and its satisfaction with plans presented in the past. Its failure to raise these issues in the bargaining sessions thus cannot fairly be read as an acquiescence in management's right unilaterally to fix bonuses—a right management never expressly claimed (R. 21; Tr. 104-107). Thus, the Board properly reasoned (R. 20):

With matters in this posture, Union acquiescence with respect to respondent's course of conduct cannot, legitimately, be found sufficient to equitably estop union spokesmen from pressing its statutory right to bargain, thereafter, regarding management's formulation and promulgation of bonus plans. *General Telephone Com-*

*pany of Florida*, 144 NLRB 311, 314-315. Management's reassurances, voluntarily proffered, regarding the presentation of new plans—while contract negotiations were pending—must, contrariwise, be considered sufficient to preclude respondent's reliance upon the union's failure to request contract negotiations on the subject as a concession that bonus plans, thereafter, would be considered within the sphere of managerial prerogative.

Furthermore, the Union did not always acquiesce in respondent's actions—or lack of them. Thus, respondent conceded in its brief to the Board that Union President Kruse “was constantly pestering the Company about incentive bonus plans” long before the 1963 negotiations (Tr. 31-33). And the record shows (*supra*, pp. 5-7) that Kruse repeatedly questioned respondent's officials about the status of the new plans it was considering and, at one point, joined other employees in the preparation of a proposed plan. In the face of these actions, and in light of respondent's repeated assurance that new plans were under study, the Union's conduct cannot fairly be interpreted as a waiver of its right to bargain about bonuses, but only as an indication that respondent's prior proposals and its promises induced the Union not to take the matter up formally in the contract negotiations.

Relying upon *Tucker Steel Corp.*, 134 NLRB 323, respondent argued to the Board that the Union was “equitably estopped” by its silence in the face of respondent's unilateral bonus changes from claiming that respondent's subsequent refusal to bargain on



that subject upon the Union's request violated the Act. There is no merit to that contention. First, *Tucker* holds to the contrary. In *Tucker*, the Board ruled that an employer's refusal to bargain upon request about a Christmas bonus violated the Act, despite the Union's prior silent acquiescence in the employer's discontinuance of the plan. *Semble, Pacific Pulp and Paper Mfrs. Ass'n v. N.L.R.B., supra*; *General Telephone Company v. N.L.R.B., supra*. True, the Board held that equitable estoppel exonerated the employer—but only from a companion charge that the unilateral discontinuance of the bonus prior to the Union's protest violated the Act. The latter holding followed because the Union had led the employer to believe that it was free to institute such changes unilaterally, and the employer could not be found to have violated the Act by acting in reliance upon the Union's conduct. But that is not this case. The propriety of respondent's unilateral changes *before* the Union invoked its right to bargain about bonuses is not at issue here.<sup>24</sup>

Second, it is hornbook law that the doctrine of equitable estoppel can be invoked only when the party invoking it shows that he will be prejudiced unless the other party is held bound by his silence.<sup>25</sup> Assuming that respondent relied upon the Union's failure to raise the bonus issue in contract negotiations, the record does not show that respondent has acted so that it will be prejudiced if it is now compelled

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<sup>24</sup> See n. 22, *supra*.

<sup>25</sup> 31 C.J.S. *Estoppel* Sec. 59 (1964).



to bargain as the Act requires. The Board's order only requires that respondent engage in good faith bargaining; it does not require that respondent accept any particular Union proposal, or, indeed, reach any agreement whatsoever. *N.L.R.B. v. American National Insurance Company*, 343 U.S. 395 cited with approval in *Pacific Coast Ass'n of Pulp and Paper Mfgers. v. N.L.R.B.*, *supra*, 304 F. 2d at 765.

Finally, respondent's premise that the doctrine of equitable estoppel by silence may be applied to prevent a union from claiming a right to bargain upon request runs counter to the decided cases holding that a valid waiver must be shown "clearly" and "unmistakably" and must have been intended. Those cases would be emptied of meaning if either party could invoke the doctrine of equitable estoppel by silence to preclude future bargaining about a subject. See cases cited *supra*, pp. 12-13.

**II. The Absence of an Arbitrator's Decision Ruling that Section 12(a) of the Contract Did Not Constitute a Waiver of the Union's Right to Bargain About Bonuses Does not Bar the Board's Finding That Respondent Violated the Act**

Before the Board, respondent urged that Section 12 (a) of the contract arguably constitutes a waiver of the Union's right to bargain about bonuses during the term of the agreement and that the Board lacks power to determine the validity of the defense. Respondent argued that only an arbitrator may decide that question. We anticipate that respondent will rely on this Court's recent decisions in *Square D Company v. N.L.R.B.*, 332 F. 2d 360, and *N.L.R.B. v. C & C Plywood Corp.*, 351 F. 2d 224, in support of

its argument. In these cases, the Court ruled that the Board could not adjudicate an unfair labor practice complaint because the determination whether the conduct complained of was in fact an unfair labor practice presented only a question of contract interpretation. This Court ruled in those cases that the Board was required to stay its hand pending resolution of the contract question either by an arbitrator, as in *Square D* where the contract provided for arbitration,<sup>26</sup> or by a court in a suit for breach of contract under Section 301 of the Labor-Management Relations Act, as in *C & C Plywood* where the contract did not provide for arbitration.<sup>27</sup> Under the Court's rationale, the Board's lack of jurisdiction was predicated on the fact that the existence of an unfair labor practice was "*dependent* upon the resolution of a primary dispute involving *only* the interpretation of the contract." *Square D Company v. N.L.R.B.*, *supra*, 332 F. 2d at 365-366 (emphasis in original). See also, *N.L.R.B. v. C & C Plywood Corp.*, *supra*, 351 F. 2d at 227.<sup>28</sup> For the reasons set out

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<sup>26</sup> There is no evidence that the Union sought to invoke the grievance-arbitration machinery in the instant case.

<sup>27</sup> Section 301(a) provides: "Suits for violation of contracts between an employer and a labor organization representing employees in an industry affecting commerce as defined in this Act, or between any such labor organizations, may be brought in any district court of the United States having jurisdiction of the parties, without respect to the amount in controversy or without regard to the citizenship of the parties."

<sup>28</sup> The Supreme Court has granted the Board's petition for certiorari in *C & C Plywood*, 86 Sup. Ct. 53 (April 18, 1966).



below, we respectfully request that this Court not follow its decisions in *C & C Plywood, supra* and *Square D, supra*.

Under the rationale applied in those cases, the Union would be required to test the validity of respondent's waiver defense in an arbitration proceeding before seeking a remedy before the Board. This would, in fact, deprive the Union of an opportunity to test that defense *in any forum*. See *Square D Co. v. N.L.R.B.*, 332 F. 2d at 362-363, 364 (Company resisted arbitration of a dispute over incentive plans because such plans were not covered by the contract and then resisted the Board's order on the ground that the issue should have been arbitrated).

There is no way that the Union can be assured that an arbitrator will decide the question whether the Union has waived its *statutory* right to *bargain* about bonuses. The contract does not afford the Union such a right. Consequently, at first glance, a grievance based on respondent's refusal to bargain about bonuses would be rejected as not arbitrable on the ground that the contract permits arbitration only "when any employee . . . or . . . the Guild believes that the employer has violated the express terms and conditions . . . [of this agreement], and that by reason of such violation his or its rights *arising out of this agreement* have been adversely affected." G.C. Exh. 2, p. 16 (emphasis supplied).<sup>29</sup> And a claim

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<sup>29</sup> The contract provides further that "the complainant in every hearing before the arbitrator shall present a prima facie case" and that "all decisions of the arbitrator shall be limited expressly to the terms and conditions of this agreement." *Id.* at p. 17.

that the contract entitles employees to bonuses would clearly be rejected on the merits and would not raise before the arbitrator the question whether the Union has a *statutory* right to *bargain* about this subject.

Moreover, even if respondent's refusal to confer about bonuses could be placed before the arbitrator on the merits, there is no assurance that the arbitrator would decide whether the Union had by contract waived its *statutory* right to bargain about bonuses. The arbitration proceeding could readily be disposed of by finding that respondent has not agreed to bargain about bonuses. Finally, even if all these obstacles to obtaining the arbitral decision could be overcome, there is no assurance that the arbitrator would decide the statutory question in the same fashion as the Board. Consequently, the upshot of requiring arbitration as a condition precedent to seeking relief from an employer's refusal to bargain where the employer presents an arguable contract defense would be either to deprive the Union of any remedy for such a violation or to run the risk of conflict between Board and arbitral decisions on the same question.

Aside from these practical considerations, we believe that the narrow view of the Board's remedial powers which this Court took in *C & C Plywood and Square D* is not in accord with Section 10(a) of the Act or with recent decisions of the Supreme Court. Section 10(a) of the Act provides that the Board's authority to prevent unfair labor practices "shall not be affected by any other means of adjustment or pre-



vention that has been or may be established by agreement, law, or otherwise.”<sup>30</sup> Congress has selected the Board, a public agency acting in the public interest, as the principal instrumentality to prevent unfair labor practices and thus to remove obstructions to interstate commerce. *Amalgamated Utility Workers v. Consolidated Edison Co.*, 309 U.S. 261, 264-265; *National Licorice Co. v. N.L.R.B.*, 309 U.S. 350, 364.<sup>31</sup>

Two Supreme Court cases, raising the question whether courts and arbitrators had jurisdiction to decide issues which might have been resolved in Board proceedings, lend further support to our position that the Board has power to adjudicate a dispute, even where that dispute may also be resolved

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<sup>30</sup> Although the contract in issue provided for arbitration, the Union did not invoke the grievance-arbitration machinery. However, even if it could have done so, this would not preclude the Board's assertion of jurisdiction to pass on the alleged violations of the Act (See, *Smith v. Evening News Association*, 371 U.S. 195, 197; *Carey v. Westinghouse Electric Corp.*, 375 U.S. 261, 272) even though the Board might choose to defer to the award of the arbitrator provided the procedure was fair and the results not repugnant to the Act. *Spielberg Mfg. Co.*, 112 NLRB 1080-1082, and cases cited in *Carey* at 375 U.S. 269-270. In the latter cases, the Board's refusal to decide the unfair labor practice issue resulted not from its lack of *power* to do so, but because the Board, as a matter of *discretion*, concluded that the policies of the Act would best be effectuated by leaving the parties to their contract remedies.

<sup>31</sup> See also, *N.L.R.B. v. Walt Disney Productions*, 146 F. 2d 44, 48 (C.A. 9), cert. denied, 324 U.S. 877, which was apparently overruled, *sub silentio*, in *Square D and C & C Plywood*.



under a contract.<sup>32</sup> In *Carey v. Westinghouse Electric Corp.*, 375 U.S. 261, the question presented was whether a court had jurisdiction under Section 301 (a) to order arbitration of a contract dispute, since the arbitrable issue could have been resolved by the Board in representation proceedings. That question would never have arisen if the presence of a contractual dispute deprives the Board of jurisdiction to proceed. Further, the Supreme Court expressly stated (375 U.S. at 272, quoting *International Harvester Co.*, 138 NLRB 923, 925-926):

There is no question that the Board is not precluded from adjudicating unfair labor practice charges even though they might have been the subject of an arbitration proceeding and award. Section 10(a) of the Act expressly makes this plain, and the courts have uniformly so held.

The Court thereafter concluded (*id.*, at 272) that “the superior authority of the Board [vis-a-vis arbitration, etc.] may be invoked at any time.”

The same question—whether the Board’s authority to remedy an unfair labor practice pre-empts the jurisdiction of courts and arbitrators—arose in *Smith v. Evening News Assn.*, 371 U.S. 195, where the Supreme Court held that a District Court had jurisdiction over a contract action alleging that plaintiff had been discharged on account of his union membership, a clear violation of Section 8(a)(3) of the Act. Had the case come before the Board, the em-

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<sup>32</sup> Accord, *Local 743, IAM v. United Aircraft Corp.*, 337 F. 2d 5, 10 (C.A. 2), cert. denied, 380 U.S. 908.

ployer might have argued that the discharge was permitted by the contract in suit, but that would not have deprived the Board of power to remedy the violation. As the Supreme Court wrote (371 U.S. 197) :

The authority of the Board to deal with an unfair labor practice which also violates a collective bargaining contract is not displaced by Section 301, but it is not exclusive and does not destroy the jurisdiction of the courts in suits under Section 301.

If the Court believed that the existence of an arguable contract defense would have precluded the Board from adjudicating a possible unfair labor practice, it would have decided *Smith* on that ground and would not have noted that the Board retained power to decide the case.<sup>33</sup>

Finally, there is no bar to the Board's assertion of jurisdiction on the principle that the Board generally does not adjudicate naked contract disputes. *N.L.R.B. v. Hyde*, 339 F. 2d 568, 572 (C.A. 9). In carrying out its responsibility to administer the Act, the Board must frequently interpret collective bargaining con-

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<sup>33</sup> In *Local 174, Teamsters v. Lucas Flour Co.*, 369 U.S. 95, in holding that a state court could adjudicate a contract claim under Section 301 of the Act, the Supreme Court noted (369 U.S. at 101, n. 9) :

It is, of course, true that conduct which is a violation of a contractual obligation may also be an unfair labor practice, and what we have said here is not to imply that enforcement of a contract obligation affects the jurisdiction of the NLRB to remedy unfair labor practices, as such.



tracts. Thus, for example, the Board has decided cases involving the legality of contract provisions under Section 8(e) of the Act; the validity of union-security clauses in cases arising under Section 8(a) (3) and (1) of the Act; and the question whether an existing contract should bar the Board from processing a representation petition and directing an election among the employees pursuant to Section 9. The Board's proceeding here was not an adjudication of a contract claim, but rather a statutory proceeding arising out of respondent's express, admitted refusal to bargain for which the contract provided no remedy. Applying the rationale of *C & C Plywood and Square D* to this case is entirely inconsistent with the Board's exercise of its authority in administering the cited provisions of the Act. We submit that ousting the Board of its jurisdiction in every case where respondent interposes a contract provision as an arguable defense—even where, as the Board found here, the defense was clearly without merit—would diminish the Board's authority under the Act far more than Congress intended by the enactment of Sections 203(d)<sup>34</sup> and 301(a) of the Labor-Management Relations Act.<sup>35</sup> So, too, the Supreme Court's expressed preference for arbitration over judicial resolution of labor disputes (see, for example, *Steelworkers v.*

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<sup>34</sup> Sec. 203(d) provides that: "[F]inal adjustment by a method agreed upon by the parties is hereby declared to be the desirable method for settlement of grievance disputes arising over the application or interpretation of an existing collective-bargaining agreement."

<sup>35</sup> See n. 27, *supra*.

*Warrior & Gulf Navigation Co.*, 363 U.S. 574) does not foreclose the parties from pursuing Board remedies rather than those afforded under the contract. See *Carey v. Westinghouse*, *supra*.

In sum, we submit that in the face of these authorities, the reasoning of this Court's *Square D* and *C & C Plywood* decisions should be reconsidered.<sup>36</sup>

### CONCLUSION

For the reasons stated, we respectfully submit that a decree should issue enforcing the Board's order in full.

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July 1966.

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<sup>36</sup> Should the Court disagree with our contention that *NLRB v. C & C Plywood Corp.*, *supra*, and *Square D Co. v. N.L.R.B.*, *supra*, should not be followed here, we respectfully request that the Court await the Supreme Court's decision in *N.L.R.B. v. C & C Plywood* before deciding the instant case.

## CERTIFICATE

The undersigned certifies that he has examined the provisions of Rules 18 and 19 of this Court, and in his opinion the tendered brief conforms to all requirements.

---

Marcel Mallet-Prevost  
Assistant General Counsel  
National Labor Relations Board



## APPENDIX

The relevant provisions of the National Labor Relations Act, as amended (61 Stat. 136, 73 Stat. 519, 29 U.S.C., Secs. 151, *et seq.*) are as follows:

## RIGHTS OF EMPLOYEES

Sec. 7. Employees shall have the right to self-organization, to form, join, or assist labor organizations, to bargain collectively through representatives of their own choosing, and to engage in other concerted activities for the purpose of collective bargaining or other mutual aid or protection, and shall also have the right to refrain from any or all of such activities except to the extent that such right may be affected by an agreement requiring membership in a labor organization as a condition of employment as authorized in section 8 (a) (3).

## UNFAIR LABOR PRACTICES

Sec. 8 (a) It shall be an unfair labor practice for an employer—

(1) to interfere with, restrain, or coerce employees in the exercise of the rights guaranteed in section 7;

\* \* \* \*

(3) by discrimination in regard to hire or tenure of employment or any term or condition of employment to encourage or discourage membership in any labor organization: *Provided*, That nothing in this Act, or in any other statute of the United States, shall preclude an employer from making an agreement with a labor organization (not established, maintained, or assisted by any action defined in section 8 (a) of this Act as an unfair labor practice) to require as a

condition of employment membership therein on or after the thirtieth day following the beginning of such employment or the effective date of such agreement, whichever is the later, \* \* \*

\* \* \* \*

(5) to refuse to bargain collectively with the representatives of his employees, subject to the provisions of section 9 (a).

\* \* \* \*

Sec. 8 (d) For the purposes of this section, to bargain collectively is the performance of the mutual obligation of the employer and the representative of the employees to meet at reasonable times and confer in good faith with respect to wages, hours, and other terms and conditions of employment, or the negotiation of an agreement, or any question arising thereunder, and the execution of a written contract incorporating any agreement reached if requested by either party, but such obligation does not compel either party to agree to a proposal or require the making of a concession: *Provided*, That where there is in effect a collective-bargaining contract covering employees in an industry affecting commerce, the duty to bargain collectively shall also mean that no party to such contract shall terminate or modify such contract, unless the party desiring such termination or modification—

(1) serves a written notice upon the other party to the contract of the proposed termination or modification sixty days prior to the expiration date thereof, or in the event such contract contains no expiration date, sixty days prior to the time it is proposed to make such termination or modification;

(2) offers to meet and confer with the other party for the purpose of negotiating a new contract or a contract containing the proposed modifications;

(3) notifies the Federal Mediation and Conciliation Service within thirty days after such notice of the existence of a dispute, and simultaneously therewith notifies any State or Territorial agency established to mediate and conciliate disputes within the State or Territory where the dispute occurred, provided no agreement has been reached by that time; and

(4) continues in full force and effect, without resorting to strike or lock-out, all the terms and conditions of the existing contract for a period of sixty days after such notice is given or until the expiration date of such contract, whichever occurs later.

\* \* \* \*

(e) It shall be an unfair labor practice for any labor organization and any employer to enter into any contract or agreement, express or implied, whereby such employer ceases or refrains or agrees to cease or refrain from handling, using, selling, transporting or otherwise dealing in any of the products of any other employer, or to cease doing business with any other person, and any contract or agreement entered into heretofore or hereafter containing such agreement shall be to such extent unenforceable and void: \* \* \*

\* \* \* \*

## REPRESENTATIVES AND ELECTIONS

Sec. 9 (a) Representatives designated or selected for the purposes of collective bargaining by the majority of the employees in a unit appropriate for such



purposes, shall be the exclusive representatives of all the employees in such unit for the purposes of collective bargaining in respect to rates of pay, wages, hours of employment, or other conditions of employment: *Provided*, That any individual employee or a group of employees shall have the right at any time to present grievances to their employer and to have such grievances adjusted, without the intervention of the bargaining representative, as long as the adjustment is not inconsistent with the terms of a collective-bargaining contract or agreement then in effect: *Provided further*, That the bargaining representative has been given opportunity to be present at such adjustment.

#### PREVENTION OF UNFAIR LABOR PRACTICES

Sec. 10 (a) The Board is empowered, as hereinafter provided, to prevent any person from engaging in any unfair labor practice (listed in section 8) affecting commerce. This power shall not be affected by any other means of adjustment or prevention that has been or may be established by agreement, law, or otherwise: \* \* \*

(b) Whenever it is charged that any person has engaged in or is engaging in any such unfair labor practice, the Board, or any agent or agency designated by the Board for such purposes, shall have power to issue and cause to be served upon such person a complaint stating the charges in that respect, and containing a notice of hearing before the Board or a member thereof, or before a designated agent or agency, at a place therein fixed, not less than five days after the serving of said complaint: *Provided*, That no complaint shall issue based upon any unfair labor practice occurring more than six months prior to the filing of the charge with the Board and the

service of a copy thereof upon the person against whom such charge is made, unless the person aggrieved thereby was prevented from filing such charge by reason of service in the armed forces, in which event the six-month period shall be computed from the day of his discharge. Any such complaint may be amended by the member, agent, or agency conducting the hearing or the Board in its discretion at any time prior to the issuance of an order based thereon.

(c) \* \* \* If upon the preponderance of the testimony taken the Board shall be of the opinion that any person named in the complaint has engaged in or is engaging in any such unfair labor practice, then the Board shall state its findings of fact and shall issue and cause to be served on such person an order requiring such person to cease and desist from such unfair labor practice and to take such affirmative action including reinstatement of employees with or without back pay, as will effectuate the policies of this Act: \* \* \*

\* \* \* \*

(e) The Board shall have power to petition any court of appeals of the United States, . . . within any circuit . . . wherein the unfair labor practice in question occurred or wherein such person resides or transacts business, for the enforcement of such order and for appropriate temporary relief or restraining order, and shall file in the court the record in the proceedings, as provided in section 2112 of title 28, United States Code. Upon the filing of such petition, the court shall cause notice thereof to be served upon such person, and thereupon shall have jurisdiction of the proceeding and of the question determined therein, and shall have power to grant such temporary re-



lief or restraining order as it deems just and proper, and to make and enter a decree enforcing, modifying, and enforcing as so modified, or setting aside in whole or in part the order of the Board. No objection that has not been urged before the Board, its member, agent, or agency, shall be considered by the court, unless the failure or neglect to urge such objection shall be excused because of extraordinary circumstances. The findings of the Board with respect to questions of fact if supported by substantial evidence on the record considered as a whole shall be conclusive. If either party shall apply to the court for leave to adduce additional evidence and shall show to the satisfaction of the court that such additional evidence is material and that there were reasonable grounds for the failure to adduce such evidence in the hearing before the Board, its member, agent, or agency, the court may order such additional evidence to be taken before the Board, its member, agent, or agency, and to be made a part of the record . . . . Upon the filing of the record with it, the jurisdiction of the court shall be exclusive and its judgment and decree shall be final, except that the same shall be subject to review by the . . . Supreme Court of the United States upon writ of certiorari or certification as provided in section 1254 of title 28.



UNITED STATES COURT OF APPEALS  
FOR THE NINTH CIRCUIT

NATIONAL LABOR RELATIONS BOARD, )

Petitioner, )

No. 20894

v. )

HONOLULU STAR-BULLETIN, INC., )  
and ADVERTISER PUBLISHING CO., )  
INC., d/b/a HAWAII NEWSPAPER )  
OPERATORS, )

On Petition for Enforcement  
of an Order of the National  
Labor Relations Board

Respondent. )

BRIEF FOR HAWAII NEWSPAPER OPERATORS, RESPONDENT

FILED

SEP 29 1966

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HONOLULU STAR-BULLETIN, INC., )  
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LTD., d/b/a HAWAII NEWSPAPER )  
OPERATORS, )

On Petition for Enforcement  
of an Order of the National  
Labor Relations Board

Respondent. )

BRIEF FOR HAWAII NEWSPAPER OPERATORS, RESPONDENT

JURISDICTIONAL STATEMENT

The National Labor Relations Board has petitioned this Court for enforcement of its order, issued on June 29, 1965, against Respondent in the case of Honolulu Star-Bulletin, Inc., et al, 153 NLRB No. 83 (R. 11-25, 30-31).<sup>1/</sup> This Court's

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<sup>1/</sup> References designated R. are to Volume I of the record. References designated Tr. are to the Official Report of Proceedings before the Trial Examiner, reproduced in Volume II of the record. References designated "Resp. Exh." or "G.C. Exh." are to exhibits of the Respondent and General Counsel, respectively. References designated "Pet. Br." are to the Brief of the General Counsel before this Court.



jurisdiction over this matter is founded upon Section 10(e) of the National Labor Relations Act, as amended (61 Stat. 136, 73 Stat. 519, 29 U.S.C. §151, et. seq.).

## STATEMENT OF THE CASE

### 1. Introduction

The National Labor Relations Board found that Respondent has, since January 2, 1964 breached its duty under Sections 8(a) (5) and (1), and 8(d), of the National Labor Relations Act, to bargain in good faith with the Union over the reinstitution of old bonus plans and the formulation of new ones. This unfair labor practice charge results from the following facts.

### 2. The Pre-Consolidation Contracts

Prior to June 1, 1962, the two Honolulu newspapers, the Advertiser and the Star-Bulletin, operated independently. The Honolulu Advertiser was published in the afternoon and the Star-Bulletin as a morning daily (Tr. 22-23). Both papers had separate collective bargaining agreements with the various newspaper unions, including the charging party, Hawaii Newspaper Guild, Local 117 (hereinafter called the Union).





Under the 1961 Star-Bulletin contract (Resp. Exh. 4) the Guild members enjoyed significant benefits not available to their counterparts employed by the Advertiser (Tr.94). However, in one respect some Advertiser Guild members were more fortunate; as an added measure of their compensation, the advertising salesmen were paid as much as ten per cent (10%) of their monthly wages through the operation of a Quarterly Bonus Plan which continued in effect from 1957 through June, 1962, the termination date of the Advertiser's separate operation (Tr. 35-36, 93, 102-103). At the Star-Bulletin, on the other hand, there was no fixed bonus for advertising salesmen. Bonus plans were instituted and discontinued according to business needs perceived by various advertising directors (Tr. 34-36, 92). These plans varied in amounts, form and purpose and thus were not a predictable part of the advertising salesmen's income.

In light of these differing practices, the collective bargaining agreements of the two papers treated bonuses differently. Both the 1961 Star-Bulletin and the Advertiser contracts contained a "minimum" salary schedule for Guild-represented employees, but both contracts also recognized the right of the employer and the individual employee to bargain for salary increases above the agreed-upon minimums as well as the employer's



right to pay amounts in excess of the minimum. Thus, the 1961

Advertiser contract contained the following clause:

Section 26(c) "Nothing in this agreement shall prevent employees from bargaining individually for salary increases above the minimum established herein, nor shall any provision herein limit the right of the Publisher to pay amounts in excess of the minimums set forth herein."

The 1961 Star-Bulletin contract (Resp. Exh. 4, p. 7) included similar language:

Section 12(b) "Nothing in this agreement shall prevent employees from bargaining individually for salary increases in excess of the minimum established herein."

"Nothing in this agreement shall limit the right of the Publisher, at its discretion, to pay amounts in excess of the salaries set forth above." (Exhibit A, to Respondent's Exhibit 4, page 6)

Presumably because at the time of the execution of the contracts employees were receiving salaries in excess of the minimums, the contracts also included a provision whereby these employees were partially protected against a reduction of their compensation. The Advertiser's contract read:

Section 26(b) "There shall be no reduction in the present salary of any employee covered by this agreement. The term 'present salary' is understood to mean the straight time rate and does not include any payments for overtime or any other extra payments."

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The counterpart clause in the Star-Bulletin contract was the most identical, with the exception that it specifically excluded the word bonus from the definition of present salary:

Section 12(a) "There shall be no reduction in the present salary of any employee covered by this agreement. The term 'present salary' is understood to mean the straight time weekly salary being paid for a work week of forty (40) hours and does not include any payments for overtime or bonus or any other extra payments."

Section 12(a) of the Star-Bulletin contract (Resp. Exh. 4) first appeared in 1956 (Tr. 87) although a company or Union witness could testify as to the history of the 1956 negotiations, Mr. Frederick Gruen, who had been director of personnel and industrial relations of the Star-Bulletin from 1959 (Tr. 87), testified that the purpose of excluding the word "bonus" from the definition of present salary in Section 12(a) was to avoid the difficulty of negotiating bonus plans which involve many variables connected with temporary assignment needs (Tr. 104-105). Union President Kruse claimed the exclusion of "bonus" from the definition was insignificant (Tr. 44-45).

### 3. The 1962 Constitution

On June 1, 1962, the two papers pooled certain facilities in order to realize efficiencies in mechanical, production,

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other clause in the Star-Bulletin agreement, was specifically agreed to by the international representative of the Guild (Tr. 100-101).

Upon the formation of HNO in June, 1962, and the execution of the interim agreement, the prior long-term Advertiser bonus was discontinued, as was a Sunday bonus plan which the Star-Bulletin had been running.<sup>1/</sup> These plans were eliminated because the consolidation eliminated their value (Tr. 101-102).

No protest from Union officials or employees followed these actions (Tr. 103). Roy Kruse, the Guild President, testified that he interpreted a company notice posted about the time of the consolidation (not placed in evidence) as stating that new bonus plans would be promulgated by the company, supposedly retroactive to June 1, and supposedly paying the same amount of money as did the recently discontinued plans (Tr. 28, 37). However, no evidence was presented and the Trial Examiner did not find that the Sunday Star-Bulletin plan supplied covered employees with compensation comparable to that the Advertiser Quarterly Bonus Plan, based as it was on six days a week, provided for its

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<sup>1/</sup> Although the Star-Bulletin was the stronger of the two newspapers, the Sunday edition was a recent innovation and the Advertiser was dominant on that day. Therefore, the Star-Bulletin limited its bonus plan to lineage sold in the Sunday paper (Tr. 102).





employees (R. 14, lines 20-23).

#### 4. Events Subsequent to the Consolidation

No new bonus plans were promulgated by the company in the summer of 1962 and it was not until September 19 that the advertising director of HNO initiated a plan for advertising lineage sold by the Saturday Star-Bulletin and the Monday Advertiser. This bonus plan was not retroactive to June 1 and did not pay amounts equal to what the Star-Bulletin employees had received prior to the consolidation, let alone what the Advertiser employees had previously enjoyed. Again, the Union did not react to the company's behaviour and although Union President Kruse testified he asked about retroactivity, he did not protest any aspect of the company's action (Tr. 30-33). This Saturday-Monday plan only benefited one or two individuals and thus was deemed a failure (Tr. 30, 91-92).

No other bonus plans were applied to advertising salesmen working at HNO through 1962. However, at the end of that year, the joint facility announced a new plan, referred to as a Monthly Team Bonus. The notice containing the plan's details specifically stated that it

"...may be revised or discontinued at any time even though the present objective is to make this effective for the first four months of 1962." (Resp. Exh. 2)



## 5. 1963 Negotiations

In the Spring of 1963, the parties negotiated for a new collective bargaining agreement to follow the interim agreement which was to expire March 31. Negotiations collapsed and the Union struck from June 22 through August 2 (R. 15, Tr. 108). A strike settlement agreement presumably settling all matters in dispute was signed on the latter date (Tr. 108).

The newspapers discontinued operations during the strike and as a result advertising customers upon resumption of operations were "hungry." It was thus deemed unnecessary to continue the monthly team bonus plan and the Saturday-Monday plan (Tr. 90-92). Accordingly, on August 5, HNO notified the advertising salesmen that both the Saturday-Monday and Monthly Team Bonus plans were "no longer in effect." The notice included the statement "new plans will be presented as soon as possible" but did not specify what kind of plans, how much money they would yield, or how long they would be in existence (R. 15, G.C. Exh. 4). Other bonus plans were, in fact, promulgated, including a new Christmas gift guide bonus.<sup>1/</sup> The Union did not dispute the company's right to discontinue these plans (Tr. 16,

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<sup>1/</sup> The Trial Examiner found (R. 16, lines 34-38) that the Christmas bonus was the only bonus plan instituted subsequent to August 5. This finding simply does not square with the testimony (Tr. 92-93).





44, 56-57, 78, 107-108).

Although the strike settlement agreement was signed August 2, the actual collective bargaining agreement was not executed until October 31, 1963. During the period between the execution of these documents, the Union did not seek to modify the collective bargaining agreement with respect to bonuses (Tr. 106-107). The subject of bonuses was not brought up by either party in the 1963 negotiations for a new collective bargaining agreement (Tr. 16, 44, 78). No official Union proposal regarding the reinstitution of bonus plans was brought to Brandt's attention between August 5, and October 31, 1963, the date when the new collective bargaining agreement was signed (Tr. 107-108), even though Brandt saw Union President Kruse nearly every day during that period (Tr. 61). Once again the Union assented to the inclusion of Section 12(a) in the collective bargaining agreement (Tr. 100). Kruse, one of the Union negotiators, testified that there was no need to negotiate about the subject of bonuses because the company had "promised" in the notice of August 5, 1963, announcing the discontinuance of the existing bonus plans that new plans were to be presented and further that the Union felt there was no need to negotiate bonuses because they were a part of the employees' basic benefits (Tr. 16, 56).



During the period of negotiations Kruse, acting as a member of a volunteer group (Tr. 59), questioned his immediate supervisor, Roy Nelson, advertising manager, about the possibility of new bonus plans, but he was given no assurance as to when new bonus plans would come in, if they were to come in, or what form they would take. He was told by various members of management, including Nelson and Carl Barrea, advertising director, that "they did not have time to develop new ideas concerning the bonus plan" (Tr. 58). Company officials during this period prior to the final execution of the new agreement, affirmed to Kruse the company's right not to bargain about the plans (Tr. 59), and affirmed that Mr. Brandt, the general manager, would not accept the plans which Kruse's volunteer group suggested (Tr. 60). Brandt indicated in this period that if the company were to accept incentive plans, they would have to cover all employees, not just advertising salesmen (Tr. 61).

#### 6. The Alleged Refusal to Bargain

On January 2, 1964, Kruse, accompanied by another Union official, Mr. Lum, went to Mr. Brandt to inquire about the likelihood of reinstitution of the bonus plans (Tr. 20, 67-68, 79). Later, specific demands to bargain regarding reinstitution of





the discontinued incentive bonuses were made to the company and were rejected.

## 7. The Trial Examiner's Decision

The Trial Examiner found that the Respondent had refused to bargain from October 1, 1963, because a reasonable construction of the collective bargaining agreement, while necessarily implying Respondent's right to reduce bonus payments or terminate specific bonus plans during the contract's term, did not in and of itself show any clear and unmistakable relinquishment of the Union's statutory right to bargain with respect to the development and promulgation of bonus plans or the correlative right of Union spokesmen to be heard with respect to their proposed modification or discontinuance (R. 19, L. 3-11). The Trial Examiner also found that the evidence could not justify a finding that the representatives of the parties, during their 1963 contract negotiations, fully discussed or consciously explored management's claim of prerogative with respect to the promulgation or termination of bonus plans and that Union spokesmen consciously yielded or clearly and unmistakably waived their constituency's interests with respect to such plans. On this basis the Trial Examiner found no waiver of the Union's





statutory right to insist upon bargaining with respect to the re-institution of bonuses (R. 19-20).

Upon review the Board upheld all the findings, conclusions and recommendations of the Trial Examiner with the exception that the Board refused to adopt the Trial Examiner's conclusion that Respondent's refusal to bargain about the bonus began as of October 1, 1963. Instead, the Board found that the refusal to bargain initially occurred on January 2, 1964, and continued thereafter (R. 30). The Board's order affirmatively requires the company to bargain upon request with respect to the formulation and reinstitution of incentive bonus plans for its employees and to post appropriate notices (R. 23-24).



## SUMMARY OF ARGUMENT

The NLRB has held that Respondent violated 8(a) (5) of the NLRA by refusing to bargain regarding the reinstitution of bonus plans it had discontinued as well as the formulation of new plans.

Respondent's defense to the petition for enforcement is the wording of its collective bargaining contract which it claims sanctioned the refusal to bargain as well as its right to discontinue the plans.

Alternatively, Respondent relies upon this Court's decision in NLRB v. C&C Plywood Corp., 351 F.2d 224, for the proposition that the Board lacked jurisdiction in this case.





## ARGUMENT

### I.

THE RESPONDENT'S REFUSAL TO ACCEDE TO THE UNION'S DEMAND TO BARGAIN OVER THE REINSTITUTION OF THE TERMINATED BONUS PLANS OR THE FORMULATION OF NEW BONUS PLANS IS SANCTIONED BY SECTION 8(d) OF THE NATIONAL LABOR RELATIONS ACT.

#### 1. The Board's Waiver Doctrine Is Inappropriately Applied

The Board has brought a wholly inapplicable standard to its analysis of this case. Respondent relies upon its collective bargaining agreement and asserts that Section 8(d) of this Act protects its refusal to bargain with the Union over the reinstitution of old or formulation of new bonus plans.<sup>1/</sup> The Board, by contract, treats this case as if the contract were silent and Respondent's defense was based on an alleged oral waiver by Union officials of the right to bargain over bonus plans. Thus, the Trial Examiner held that the Union did not

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<sup>1/</sup> Section 8(d) "...and the duties so imposed shall not be construed as requiring either party to discuss or agree to any modification of the terms and conditions contained in a contract for a fixed period, if such modification is to become effective before such terms and conditions can be reopened under the provisions of the contract."



"consciously" yield or "clearly and unmistakably" waive its right to bargain with respect to bonus plans (R. 18-21). The Board, adopting the Trial Examiner's decision, adds the adjective "unambiguously" to "clearly and unmistakably" (R. 30). It is respectfully submitted the Board has no warrant to formulate this unusually stringent standard for the interpretation of collective bargaining agreements which actually results in shifting the burden of proof on to the Respondent.<sup>1/</sup>

The entire argument presented on pages 11 through 20 of the Board's Brief is totally inapposite since it deals with the Board's waiver doctrine as applied to situations where the collective bargaining agreement is silent on the subject proposed for bargaining. Whatever may be the justification for imposing such a heavy burden upon an employer who seeks to assert a Union waiver of its right to bargain based on negotiation history, there is no reason to apply this standard to the interpretation of collective bargaining agreements.

The Board rationalizes its "waiver doctrine" on the grounds that a less stringent standard would result in the reluctance of contracting parties to discuss matters during

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<sup>1/</sup> The burden, furthermore, is analogous to beyond a reasonable doubt which, applied to a defendant is an ironic twist.





negotiations (Pet. Br. pp. 14-16). This rationale has no meaning here since we are faced with an interpretation of language which the parties agreed upon and did place in the contract. The Board's Brief further points out to the Court the general advantages of a continuing collective bargaining process. Surely the Board does not imply that it seeks to "reverse" Section 8(d) of the National Labor Relations Act which enunciates an opposite policy with respect to bargaining which would modify collective bargaining agreements during their term. Indeed, national labor policy clearly supports the use of grievance procedures and arbitration as the proper continuation of collective bargaining with respect to matters covered in an existing contract. United Steelworkers v. Warrior & Gulf Navigation Co., 363 U.S. 574 (1960).

If this case represents an attempt by the Board to extend its waiver doctrine to the interpretation of contract language it is without prior judicial support. In fact, the only cases which the Board relies upon to sanction its "clear and unmistakable" standard as applied to contract interpretation are: Timken Roller Bearing Co. v. NLRB, 325 F.2d 746 (6th Cir. 1963); NLRB v. Otis Elevator Co., 208 F.2d 176 (2nd Cir. 1953); NLRB v. Item Co., 220 F.2d 956 (5th Cir. 1955); Tidewater Associated





Oil Co., 85 NLRB 1096 (1949) (Pet. Br., p. 22).

Actually, Timken and the Item case cited by the Timken court both involved contracts which were silent on the crucial issue. The Respondent in those cases claimed that the Unions had waived their right to bargain over the matter because the Union had dropped a proposed clause during negotiations. Although in Otis the company relied upon a contract clause to justify its refusal to give the Union certain information on the grounds that the clause occupied the field, in fact, the obligations set forth in the clause were clearly not inconsistent with the requested information. The Tidewater case decided in 1949 appears to be the original source of the Board's "clear and unmistakable" doctrine as applied to interpretation of a contract. The Board did not in that case, however, hold that the contract clause itself had to present a "clear and unmistakable" waiver<sup>1/</sup> and indeed, the same Board shortly thereafter indicated in Standard Oil Co., 92 NLRB 227 (1950), that a "clear and unmistakable" waiver is reflected by a "reasonable construction" of contract language (at 228).

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<sup>1/</sup> In that case, the employer did not rely upon its contract in refusing to bargain.



Thus, the Board has recognized that if an employer's refusal to bargain is predicated on a reasonable construction of the contract it would be unjust to hold him guilty of an unfair labor practice. If the Board were to consistently apply this standard which it has never overruled, it would not be faced with the "problem" which seems to underlie its disagreement with this Court's decision in Square D Co. v. NLRB, 332 F.2d 360 (9th Cir. 1964), and NLRB v. C & C Plywood Corp., 351 F.2d 224 (9th Cir. 1965), the danger that an arbitrator might interpret the contract differently from the Board (Pet. Br., p. 31). In contrast to this case and C & C Plywood, the Board has in other cases seemed to follow the analysis foreshadowed in the Standard Oil decision. Leroy Machine Co., Inc., 147 NLRB 1431 (1964), Borden Co., 110 NLRB 127 (1954), and Buick-Oldsmobile-Pontiac Assembly Division of General Motors, 149 NLRB 40 (1964).

2. The Plain Meaning of the Contract Supports Respondent's Refusal to Bargain Over the Discontinued Bonus Plans.

Whatever standard is applied to the instant case it is respectfully submitted that the contract amply justifies Respondent's refusal to bargain over bonus plans.

The agreement in effect at the time of the alleged refusal to bargain contemplated payments to employees of amounts





in excess of the minimum salary schedule solely at the discretion of the employer. The last sentence of Exhibit A reads:

"Nothing in this agreement shall limit the right of the employer at its discretion to pay amounts in excess of the salary set forth above." 1/ (Emphasis added)

Although HNO was granted this right as well as the right to bargain individually with employees for salary increases [12(b)], the employees were partially protected against reduction of their total income by Section 12(a):

"There shall be no reduction in the present salary of any employee covered by this agreement. The term 'present salary' is understood to mean the straight time weekly salary being paid for a work week of forty (40) hours and does not include any payments for overtime or bonus or any other extra payments."

Exhibit A's last sentence grants to Respondent plenary authority concerning the institution of any payments to employees above minimum salaries. The word "amounts" must refer to bonuses as well as increases in salaries since when the parties meant to limit the operation of contract language to salaries they specifically did so:<sup>2/</sup>

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- 1/ This sentence was not specifically urged upon the Board but the whole collective bargaining agreement is in evidence.
- 2/ It is expected that the Board in its Reply Brief will claim that the last sentence of Exhibit A deals only with individual bonuses and not group plans since an analogous clause was so interpreted in C & C Plywood, 148 NLRB 414, 417; however, there the clause referred to "individual" premium pay



"(b) Nothing in this agreement shall prevent employees from bargaining individually for salary increases in excess of the minimum established herein." 1/ (Emphasis added)

Section 12(a) although freezing past salary increases, contains a grant of even greater management right over bonuses since it, by excluding bonus from the definition of present salary, allows the Respondent to discontinue bonus plans at will. It would have been understandable had the parties treated bonuses in the same manner as salary increases, i.e., allowing management to increase bonuses at its discretion but forbidding decreases below the level employees enjoyed upon execution of the agreement. Instead, 12(a) indicates that the Union either regarded bonuses a less essential aspect of total compensation or that it agreed with management as to the practical necessity of allowing Respondent free rein concerning this matter. The use of the adjective "extra" to describe bonuses reinforces this interpretation.

The Star-Bulletin's collective bargaining agreement which preceded Respondent's Exhibit 4 contained the same language as the instant HNO agreement. The Advertiser contract on the other

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1/ Obviously, the parties considered individual bargaining as appropriate only for salary increases and not for bonuses.





hand, differed in that bonuses were not defined as extra payments and were obviously regarded by the parties as part of the advertising salesmen's "present salary," thus the Advertiser would not have been entitled to reduce or terminate the Quarterly Bonus plan which provided over a long period of time a significant amount of the advertising salesmen's income.<sup>1/</sup> The same Union, indeed the same officials (Tr. 27-28, 35, 47-48), were involved in the negotiations of both the Advertiser and the Star-Bulletin agreements. They must then be read in paria materia and their differences granted the significance they obviously deserve.

The Board, although appearing to concede that 12(a) of the agreement grants Respondent the right to terminate bonuses, denies that this right includes the privilege of refusing to bargain over the reinstitution of the bonus plans

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<sup>1/</sup> Even the Advertiser presumably would have been entitled to refuse to discuss the promulgation of new plans since its agreement (Resp. Exh. 1) also stated, "...nor shall any provision herein limit the right of the Publisher to pay amounts in excess of the minimums set forth herein."





once discontinued.<sup>1/</sup> This is so because "the contract does not contain any express waiver of the Union's right to bargain about bonuses" (Pet. Br., p. 21, R. 18-19). Again, it is submitted that the Board's reasoning is faulty resulting in an artificial dichotomy. Few labor contracts contain express waivers concerning subjects discussed therein, yet a party is entitled to refuse to discuss matters brought up during the life of the agreement if the discussion involves matters which, if agreed to, would result in the modification of the contract. Thus, a contract containing a wage scale does not normally include a written statement to the effect that the Union waives its right to bargain about wages during the life of the agreement but the employer is privileged to refuse to discuss wages for classifications embodied in the contract because such a discussion necessarily involves a prospective change in the

1/ The Board's Brief states that "Section 12(a), at most, frees the Respondent of any contractual obligation to maintain bonuses throughout the contract period" (Pet. Br., p. 21), and that "...a claim that the contract entitles employees to bonuses would clearly be rejected [by an arbitrator] on the merits..." (Pet. Br., pp. 30-31). The Trial Examiner interpreted the contract as granting the right to terminate bonus plans but not the right to do so unilaterally (R. 19). The Board's Brief makes no attempt to defend this fantastic interpretation.



contract. The proper question then is: did the Union's request actually involve a discussion pointing to a modification of the agreement?

The Board's restrictive interpretation of the contract, at least as articulated in its Brief, is based on three observations (Pet. Br., pp. 21-24). One of these is that although overtime is excluded from the definition of present salary in 12(a), another section specifies that if overtime was provided, it would be paid at one-and-one-half (1 1/2) times the basis straight hourly wage. The Board argues that since the parties dealt with overtime elsewhere in the contract, 12(a) could not have constituted a grant of management prerogative concerning overtime. But Section 10(c) read with Section 12(a) indicates that the former is no more than a proviso, and a limited one at that, since it simply repeats obligations set forth under the Fair Labor Standards Act.<sup>1/</sup> Notwithstanding 10(c), 12(a) clearly grants to the employer the right to eliminate overtime altogether and thus a Union demand to bargain about more overtime would be properly rejected as was the

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<sup>1/</sup> See 29 U.S.C. Section 207(a)(1)





demand to bargain about more bonuses. Secondly, the Board contends that the contract contains no identified quid pro quo in exchange for the Union's relinquishment of its right to bargain over the reinstitution of bonus plans legally discontinued (Pet. Br., p. 23). This reflects an extremely naive view of the collective bargaining process. Surely any one versed in collective bargaining negotiations or, indeed, negotiations for any contract, realizes that everything one party gets in the contract is a quid pro quo for everything received by the other party.<sup>1/</sup> The only possible explanation for this argument is an underlying Board view that the Union should not have granted this right to the employer without getting for its members some bonus plan benefit. The United States Supreme Court, however, has forbidden the Board to exercise this kind of judgment as an adjunct to its decision-making process:

"Thus, it is now apparent from the statute itself that the Act does not encourage a party to engage in fruitless marathon discussions at the expense of frank statements in support of

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<sup>1/</sup> The no-strike clause and arbitration provisions are often paired only because one makes little sense without the other.



his position. And, it is equally clear that the Board may not, either directly or indirectly, compel concessions or otherwise sit in judgment upon the substantive terms of collective bargaining agreements." NLRB v. American National Insurance Co., 343 U.S. 395, 404 (1952).

The Board also insists (reflecting the Trial Examiner's reasoning) that the contract cannot be interpreted in the manner Respondent urges since there is no evidence that either party specifically stated in negotiations that the contract clauses involved were meant to "waive" the Union's right to bargain about bonus plans (Pet. Br., p. 22, R. 19). Actually, since waiver is an inappropriate word to apply, it is not surprising that no such evidence was produced. In any event, although Respondent asserts the plain meaning of the contract, the conduct of the parties prior to and after the execution of the collective bargaining agreement reflects their common interpretation.

To return to the determinative question: does the Union's request to bargain over the discontinuance of old plans and the institution of new ones necessarily involve discussion of the modification of contractual terms? Respondent asserts that it does.

It seems self-evident that the last sentence of Exhibit





A<sup>1/</sup> grants a great measure of discretion to Respondent which would be restricted by any obligation to bargain over the formulation of new bonus payments. Any such restriction whether ordered by the Board or bargained by the Union obviously modifies this contract provision. Furthermore, 12(a) by itself, even as construed by the Board, contains a necessary grant of sole authority over new plans and would similarly be modified by the Board's order. The greater power of termination, which is conceded, necessarily implies the lesser authority of formulation. Compare Leroy Machine Co., Inc., 147 NLRB 1431 (1964), where the Board decided that a contract clause which granted to the employer the sole right to determine an employee's qualifications encompassed the lesser right to give physical examinations.

The Board's order vividly illustrates this principle by requiring the employer to bargain over the very plans he legally discontinued. Surely if a contract grants the employer the right to abolish the bonuses, the Board's order conflicts

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<sup>1/</sup> "Nothing in this agreement shall limit the right of the Publisher, at its discretion, to pay amounts in excess of the salaries set forth above."





directly with the contract. It is inconceivable that when Section 12(a) was negotiated the Union agreed to grant the employer the power to abrogate bonus plans but reserved the right to immediately thereafter bargain about the reinstitution of the same plans. Such a contractual interpretation is utterly unreasonable.

A direct conflict between the Union's bargaining demand and the Board order on the one hand and the agreement on the other is further illustrated by the following example: Assume that the employer is obliged pursuant to the order to bargain with the Union regarding a bonus plan. The parties negotiate for several months and the Union, through the auspices of a strike threat, forces the company to agree to a new bonus plan.<sup>1/</sup> The Union would have the unquestioned right pursuant to Section 8(d) of the Act to insist that the agreed-upon bonus plan be incorporated into the collective bargaining agreement.<sup>2/</sup> This cannot possibly be reconciled with the company's

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<sup>1/</sup> It is not at all clear that the no-strike clause in the collective bargaining agreement would prohibit such a strike, since it is arguable that it applies only to matters already bargained.

<sup>2/</sup> "For the purpose of this section, to bargain collectively means the negotiation of an agreement, or any question arising thereunder, and the inclusion of a written contract incorporating any agreement reached if requested by either party,..." [Section 8(d)].



conceded right to revoke the bonus plan.

If, in the light of this paradox, the Board order does not require the written incorporation of any bonus plan agreement, then the obligation to bargain about discontinued or new bonus plans is meaningless since Respondent would be entitled to revoke any plans at his discretion. If this is so, to force discussion of the plans is capricious.

3. Respondent's Interpretation of the Meaning of the Collective Agreement is Supported by the Parties' Conduct

It is a well-settled rule that, in interpretation of a contract clause which is arguably susceptible to more than one meaning,<sup>1/</sup> the Court will place great weight upon conduct of the parties before the controversy arises which indicates the meaning they have placed upon the clause. 4 WILLISTON ON CONTRACTS, §623 (1961 ed.). This Court has applied the above rule in several cases to interpret contractual provisions. In Pacific Portland Cement Co. v. Food Machine & Chemical Corp., 178 F.2d 541, this

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<sup>1/</sup> Respondent does not, of course, concede that the contract is susceptible to any meaning other than that advanced in this brief.





Court said, at 554:

...the conduct of the parties subsequent to the execution of the contract and before the controversy arose... is given due consideration in determining the meaning of a contract, because it may indicate the actual, practical construction which the parties have placed upon the contract." (9th Cir. 1949)

See also Continental Assurance Co. v. Conroy, 209 F.2d 539, 542-543 (3rd Cir. 1954); Pekovich v. Coughlin, 258 F.2d 191, 193 (9th Cir. 1958). The rule has been applied in the labor-management field to construe an arbitration submission pursuant to a collective bargaining agreement, United Steelworkers v. Northwest Steel Rolling Mills, Inc., 324 F.2d 479, 482 (9th Cir. 1963).

Assuming, arguendo, that in the instant case the collective bargaining agreement is susceptible of more than one interpretation evidence regarding the parties' conduct since 1956 is relevant in interpreting its meaning.<sup>1/</sup> This evidence indicates clearly that prior to the instant controversy both parties

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<sup>1/</sup> The post-1956 conduct of the parties is relevant since §12(a) first appeared in the Star Bulletin Guild collective agreement in 1956 (Tr. 98).



understood that the collective agreement treated bonuses as a management prerogative.<sup>1/</sup>

Numerous instances of management conduct since 1956 have demonstrated to the Union the company's believes that the collective bargaining agreement gives it exclusive control over the existence of bonus plans. The Union response, or lack thereof, to these courses of conduct indicates that until the present controversy arose the Union has understood and acquiesced in this belief:

First, from the initial inclusion of Section 12(a) in the 1956 collective agreement, up to the June 1, 1962, consolidation into HNO, the Honolulu Star-Bulletin had implemented and discontinued a number of bonus plans at will (Tr. 33, 36-37, 92-94, 103-104). The Union at no time protested this conduct (Tr. 103-104).

Second, upon the formation of HNO on June 1, 1962, that agency unilaterally discontinued both the Advertiser Quarterly Bonus Plan (in existence since 1957) and the Star-Bulletin Sunday Bonus Plan (of short duration) (Tr. 28, 35, 37-39, 62, 101-103).

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<sup>1/</sup> HNO General Manager Fred Brandt testified that Section 12(a) was in the collective bargaining agreement for the sole purpose of holding for management the "unilateral right to put in and take out bonus plans" (Tr. 105). Union President Kruse testified that, in his opinion, Section 12(a) did not give management the right to reduce bonuses (Tr. 44-45), but in other testimony he reveals that he was aware of management's position that the agreement gave it the right to do just that (Tr. 30-31, 36, 56, 59, 71-73).





The Union at no time protested these actions (R.21; Tr. 103). Moreover, it had agreed to the insertion of Section 12(a) in the 1962 interim agreement shortly before HNO discontinued these plans. The Union had brought a "top-notch" international representative to Hawaii to analyze the Star-Bulletin and Advertiser collective bargaining agreements and decided that the interim agreement should simply extend the Star Bulletin contract to all employees working at HNO (Tr. 47, 101).

Third, the notice distributed to advertising employees in February, 1963, which described Respondent's new Monthly Bonus Plan, contained the statement that the new plan might be "revised or discontinued at any time."<sup>1/</sup> The Union at no time challenged management's right to revise or discontinue this plan (R.21).

Fourth, the Respondent unilaterally discontinued the Saturday-Monday and monthly bonus plans on August 5, 1963 (Tr. 89-92).<sup>2/</sup> The Union remained silent. (R. 21, lines 37-39).

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1/ This notice also stated that at the time management planned to keep the new plan in effect for at least four months (Resp.Ex.2)

2/ Union President Kruse testified that the Union did not bargain about bonuses in the 1963 negotiations because it felt it had a written "promise" from the company that new plans were forthcoming (Tr. 15, 56). This was based on a sentence at the foot of the August fifth notice which said "New plans will be presented as soon as possible" (G.C.Ex.4). This sentence, read in the context of the entire notice and the surrounding circumstances, is in fact a reassertion of management's basic position on bonuses.





Fifth, company communications regarding bonus plans were at all times directed to individual employees, rather than the Union (Tr. 15, 37).

Finally, the company had, at various times before the present controversy arose, communicated to employees, including Union President Kruse, its position that bonuses were a matter of management prerogative and were not bargainable during the term of the collective agreement (Tr. 17-18, 31-33, 58-59).<sup>1/</sup> The Union did not dispute this assertion at any time. Indeed Kruse, as part of a volunteer committee, presented suggested bonus plans to the advertising department supervisors during the very time the 1963 negotiations were taking place (Tr. 58-59). Although Kruse was also a Union negotiator, bonus plans were not mentioned in the negotiations (Tr. 106-107).

In spite of the above evidence, the Trial Examiner rejects Respondent's contention that management's position regarding its rights under the collective bargaining agreement was known to the Union. It is submitted that this finding is not based on substantial evidence and must be disregarded by the Court. In light of the Union's conduct in this case the fact that the question of bonuses was not discussed in negotiations simply indi-

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<sup>1/</sup> Kruse testifies that management told him in September 1963 that the subject of bonuses was not negotiable (Tr. 59).



cates that the Union acquiesced in the continuation of management rights over bonuses during the term of the new contract.<sup>1/</sup>

The Board is truly engaged in an

"...attempt to bestow upon Respondent's Union employees the benefits which it believes the Union should have obtained but failed to obtain for them as a result of its collective bargaining with the Respondent on their behalf." [NLRB v. Nash-Finch Co., 211 F.2d 622, 627 (8th Cir. 1954)]

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<sup>1/</sup> The execution of the contract in the face of management's claimed prerogative would, even if the contract were silent, constitute a waiver of the Union's right to bargain over bonuses. Speidel Corp., 120 NLRB 733 (1958), cf. Tucker Steel, 134 NLRB 323 (1961).





## II.

THE BOARD HAS NO JURISDICTION TO ENTERTAIN THIS CASE IN THE ABSENCE OF AN ARBITRATOR'S INTERPRETATION OF THE CONTRACT.

The contract (G.C. Exh. 2) contains a grievance procedure which culminates in arbitration.<sup>1/</sup> This Court has recently held that where an unfair labor practice is predicated on interpretation of a collective bargaining agreement, the Board must await an arbitrator's decision (or a Court's if no arbitration clause exists). NLRB v. C & C Plywood Corp., 351 F.2d 224 (9th Cir. 1965) Square D Co. v. NLRB, 332 F.2d 360 (9th Cir. 1964). See also, Sinclair Refining Co. v. NLRB 306 F.2d 569 (5th Cir. 1962). Presumably then the issue is foreclosed here.<sup>2/</sup> The arguments presented by the Board in its Brief urging reconsideration of this Court's view of the problem were undoubtedly raised in the C & C Plywood case, and the Respondent does not wish to tax the Court with a reargument of the same issue. Suffice is to say that the two decisions on which the Board primarily relies, Carey v. Westinghouse Electric Corp., 375 U.S. 261 (1965) and Smith v. Evening News Association, 371 U.S. 195 (1962), did not involve cases

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<sup>1/</sup> See Exhibit A to this brief (Section 24).

<sup>2/</sup> C & C Plywood, as the Board's Brief indicates, is now to be argued before the Supreme Court. 86 Sup.Ct. 53.



where an unfair labor practice holding was necessarily based on 1/ an interpretation of a collective bargaining agreement.

There remains the question as to whether the charging party in this case could have presented to an arbitrator the very issue which the Board decided. The Board contends in its Brief that the Union would not have been entitled to present the "statutory question" to the arbitrator. It is respectfully submitted that again the Board indulges in a sophistic split of what, in fact, is one issue. The Union would certainly have been entitled to test the company's position in arbitration by alleging that Respondent's refusal to bargain over the reinstitution of bonus plans was a specific violation of Section 1 of the agreement:

"Section 1. UNION RECOGNITION AND UNION SECURITY. The employer recognizes the Guild as the sole and exclusive collective bargaining agent for all employees covered by this agreement."

The recognition clause of a collective bargaining agreement is

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1/ Interestingly, although this point is not conceded in the Board's Brief to this Court, it is forthrightly mentioned in its petition for certiorari. "Furthermore, in those cases no question of contract interpretation would have had to be resolved by the Board for it to determine whether an unfair labor practice had been committed. The provisions of the collective bargaining contracts on which the suits were based in each case merely repeated prohibitions contained in the National Labor Relations Act.... Here, [C&C Plywood] it would have been impossible for the Board to adjudicate the unfair labor practice complaint without interpreting the contract." pp. 9-10.





often the vehicle by which a Union raises a grievance. It impliedly embodies much the same obligations as those set forth in 8(a) 5 of the National Labor Relations Act. The Union's claim would be that the employer, by refusing to bargain over the reinstitution of the bonus plans, violated its obligation to recognize the Guild as the employee's exclusive bargaining agent. The Respondent faced with this argument would have been forced to base his defense on Section 12(a) and Exhibit A of the agreement. There is no doubt that the arbitrator would have decided the very issue which the Board seeks to reserve for itself. Of course, the Union did not, in fact, seek arbitration of this dispute, and, under the terms of Section 24, the employer has no right to initiate arbitration.

The Board's argument on this issue does contain one point which Respondent is willing to concede. If the Board continues to use its extraordinary waiver standard in interpreting collective bargaining agreements there will undoubtedly be a high "risk of conflict" between Board and arbitration decisions (Board's Brief, P. 31). This risk would be minimized if the Board were not to issue a complaint in such a case as this if the party asserting the right not to bargain points to a reasonable or arguable interpretation of its agreement. Indeed, the





only possible way conflicts can be avoided is by the Board's adoption of this suggested procedure.

Respondent is further willing to concede that had this case been presented to an arbitrator a conflicting decision would have resulted. This is precisely the reason why the Respondent is not guilty of an unfair labor practice.



Court said, at 554:

...the conduct of the parties subsequent to the execution of the contract and before the controversy arose... is given due consideration in determining the meaning of a contract, because it may indicate the actual, practical construction which the parties have placed upon the contract." (9th Cir. 1949)

See also Continental Assurance Co. v. Conroy, 209 F.2d 539, 542-543 (3rd Cir. 1954); Pekovich v. Coughlin, 258 F.2d 191, 193 (9th Cir. 1958). The rule has been applied in the labor-management field to construe an arbitration submission pursuant to a collective bargaining agreement, United Steelworkers v. Northwest Steel Rolling Mills, Inc., 324 F.2d 479, 482 (9th Cir. 1963).

Assuming, arguendo, that in the instant case the collective bargaining agreement is susceptible of more than one interpretation evidence regarding the parties' conduct since 1956 is relevant in interpreting its meaning.<sup>1/</sup> This evidence indicates clearly that prior to the instant controversy both parties

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<sup>1/</sup> The post-1956 conduct of the parties is relevant since §12(a) first appeared in the Star Bulletin Guild collective agreement in 1956 (Tr. 98).





understood that the collective agreement treated bonuses as a management prerogative.<sup>1/</sup>

Numerous instances of management conduct since 1956 have demonstrated to the Union the company's believes that the collective bargaining agreement gives it exclusive control over the existence of bonus plans. The Union response, or lack thereof, to these courses of conduct indicates that until the present controversy arose the Union has understood and acquiesced in this belief:

First, from the initial inclusion of Section 12(a) in the 1956 collective agreement, up to the June 1, 1962, consolidation into HNO, the Honolulu Star-Bulletin had implemented and discontinued a number of bonus plans at will (Tr. 33, 36-37, 92-94, 103-104). The Union at no time protested this conduct (Tr. 103-104).

Second, upon the formation of HNO on June 1, 1962, that agency unilaterally discontinued both the Advertiser Quarterly Bonus Plan (in existence since 1957) and the Star-Bulletin Sunday Bonus Plan (of short duration) (Tr. 28, 35, 37-39, 62, 101-103).

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<sup>1/</sup> HNO General Manager Fred Brandt testified that Section 12(a) was in the collective bargaining agreement for the sole purpose of holding for management the "unilateral right to put in and take out bonus plans" (Tr. 105). Union President Kruse testified that, in his opinion, Section 12(a) did not give management the right to reduce bonuses (Tr. 44-45), but in other testimony he reveals that he was aware of management's position that the agreement gave it the right to do just that (Tr. 30-31, 36, 56, 59, 71-73).



The Union at no time protested these actions (R.21; Tr. 103). Moreover, it had agreed to the insertion of Section 12(a) in the 1962 interim agreement shortly before HNO discontinued these plans. The Union had brought a "top-notch" international representative to Hawaii to analyze the Star-Bulletin and Advertiser collective bargaining agreements and decided that the interim agreement should simply extend the Star Bulletin contract to all employees working at HNO (Tr. 47, 101).

Third, the notice distributed to advertising employees in February, 1963, which described Respondent's new Monthly Bonus Plan, contained the statement that the new plan might be "revised or discontinued at any time."<sup>1/</sup> The Union at no time challenged management's right to revise or discontinue this plan (R.21).

Fourth, the Respondent unilaterally discontinued the Saturday-Monday and monthly bonus plans on August 5, 1963 (Tr. 89-92).<sup>2/</sup> The Union remained silent. (R. 21, lines 37-39).

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1/ This notice also stated that at the time management planned to keep the new plan in effect for at least four months (Resp.Ex.2)

2/ Union President Kruse testified that the Union did not bargain about bonuses in the 1963 negotiations because it felt it had a written "promise" from the company that new plans were forthcoming (Tr. 15, 56). This was based on a sentence at the foot of the August fifth notice which said "New plans will be presented as soon as possible" (G.C.Ex.4). This sentence, read in the context of the entire notice and the surrounding circumstances, is in fact a reassertion of management's basic position on bonuses.





Fifth, company communications regarding bonus plans were at all times directed to individual employees, rather than the Union (Tr. 15, 37).

Finally, the company had, at various times before the present controversy arose, communicated to employees, including Union President Kruse, its position that bonuses were a matter of management prerogative and were not bargainable during the term of the collective agreement (Tr. 17-18, 31-33, 58-59).<sup>1/</sup> The Union did not dispute this assertion at any time. Indeed Kruse, as part of a volunteer committee, presented suggested bonus plans to the advertising department supervisors during the very time the 1963 negotiations were taking place (Tr. 58-59). Although Kruse was also a Union negotiator, bonus plans were not mentioned in the negotiations (Tr. 106-107).

In spite of the above evidence, the Trial Examiner rejects Respondent's contention that management's position regarding its rights under the collective bargaining agreement was known to the Union. It is submitted that this finding is not based on substantial evidence and must be disregarded by the Court. In light of the Union's conduct in this case the fact that the question of bonuses was not discussed in negotiations simply indi-

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<sup>1/</sup> Kruse testifies that management told him in September 1963 that the subject of bonuses was not negotiable (Tr. 59).





cates that the Union acquiesced in the continuation of management rights over bonuses during the term of the new contract.<sup>1/</sup>

The Board is truly engaged in an

"...attempt to bestow upon Respondent's Union employees the benefits which it believes the Union should have obtained but failed to obtain for them as a result of its collective bargaining with the Respondent on their behalf." [NLRB v. Nash-Finch Co., 211 F.2d 622, 627 (8th Cir. 1954)]

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<sup>1/</sup> The execution of the contract in the face of management's claimed prerogative would, even if the contract were silent, constitute a waiver of the Union's right to bargain over bonuses. Speidel Corp., 120 NLRB 733 (1958), cf. Tucker Steel, 134 NLRB 323 (1961).



## II.

THE BOARD HAS NO JURISDICTION TO ENTERTAIN THIS CASE IN THE ABSENCE OF AN ARBITRATOR'S INTERPRETATION OF THE CONTRACT.

The contract (G.C. Exh. 2) contains a grievance procedure which culminates in arbitration.<sup>1/</sup> This Court has recently held that where an unfair labor practice is predicated on interpretation of a collective bargaining agreement, the Board must await an arbitrator's decision (or a Court's if no arbitration clause exists). NLRB v. C & C Plywood Corp., 351 F.2d 224 (9th Cir. 1965) Square D Co. v. NLRB, 332 F.2d 360 (9th Cir. 1964). See also, Sinclair Refining Co. v. NLRB 306 F.2d 569 (5th Cir. 1962). Presumably then the issue is foreclosed here.<sup>2/</sup> The arguments presented by the Board in its Brief urging reconsideration of this Court's view of the problem were undoubtedly raised in the C & C Plywood case, and the Respondent does not wish to tax the Court with a reargument of the same issue. Suffice is to say that the two decisions on which the Board primarily relies, Carey v. Westinghouse Electric Corp., 375 U.S. 261 (1965) and Smith v. Evening News Association, 371 U.S. 195 (1962), did not involve cases

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<sup>1/</sup> See Exhibit A to this brief (Section 24).

<sup>2/</sup> C & C Plywood, as the Board's Brief indicates, is now to be argued before the Supreme Court. 86 Sup.Ct. 53.





where an unfair labor practice holding was necessarily based on 1/  
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There remains the question as to whether the charging party in this case could have presented to an arbitrator the very issue which the Board decided. The Board contends in its Brief that the Union would not have been entitled to present the "statutory question" to the arbitrator. It is respectfully submitted that again the Board indulges in a sophistic split of what, in fact, is one issue. The Union would certainly have been entitled to test the company's position in arbitration by alleging that Respondent's refusal to bargain over the reinstitution of bonus plans was a specific violation of Section 1 of the agreement:

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often the vehicle by which a Union raises a grievance. It impliedly embodies much the same obligations as those set forth in 8(a) 5 of the National Labor Relations Act. The Union's claim would be that the employer, by refusing to bargain over the reinstitution of the bonus plans, violated its obligation to recognize the Guild as the employee's exclusive bargaining agent. The Respondent faced with this argument would have been forced to base his defense on Section 12(a) and Exhibit A of the agreement. There is no doubt that the arbitrator would have decided the very issue which the Board seeks to reserve for itself. Of course, the Union did not, in fact, seek arbitration of this dispute, and, under the terms of Section 24, the employer has no right to initiate arbitration.

The Board's argument on this issue does contain one point which Respondent is willing to concede. If the Board continues to use its extraordinary waiver standard in interpreting collective bargaining agreements there will undoubtedly be a high "risk of conflict" between Board and arbitration decisions (Board's Brief, P. 31). This risk would be minimized if the Board were not to issue a complaint in such a case as this if the party asserting the right not to bargain points to a reasonable or arguable interpretation of its agreement. Indeed, the





only possible way conflicts can be avoided is by the Board's adoption of this suggested procedure.

Respondent is further willing to concede that had this case been presented to an arbitrator a conflicting decision would have resulted. This is precisely the reason why the Respondent is not guilty of an unfair labor practice.





## CONCLUSION

This case turns on the interpretation of a contract. Therefore, this Court is faced with a traditional question of law over which the Labor Board can assert no special expertise. If the Court agrees with Respondent's interpretation, the Board's petition for enforcement must be denied and there is no necessity to wait for the Supreme Court's decision in C & C Plywood.

It is respectfully submitted that any reasonable construction of the collective bargaining agreement justifies Respondent's action; it did not violate the National Labor Relations Act.

Respectfully submitted,

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Attorney for Respondent

Of Counsel



## APPENDIX

The relevant provisions of the National Labor Relations Act, as amended (61 Stat. 136, 73 Stat. 519, 29 U.S.C., Sections 151, et. seq.) are as follows:

### RIGHTS OF EMPLOYEES

Section 7. Employees shall have the right to self-organization, to form, join, or assist labor organizations, to bargain collectively through representatives of their own choosing, and to engage in other concerted activities for the purposes of collective bargaining or other mutual aid or protection, and shall also have the right to refrain from any or all of such activities except to the extent that such right may be affected by an agreement requiring membership in a labor organization as a condition of employment as authorized in Section 8(a)(3).

### UNFAIR LABOR PRACTICES

Section 8(a). It shall be an unfair labor practice for an employer ---





(1) to interfere with, restrain, or coerce employees in the exercise of the rights guaranteed in Section 7;....

(5) to refuse to bargain collectively with the representatives of his employees, subject to the provisions of Section 9(a).....

Section 8(d). For the purposes of this section to bargain collectively is the performance of a mutual obligation of the employer and the representative of the employees to meet at reasonable times and confer in good faith with respect to wages, hours, and other terms and conditions of employment, or the negotiation of an agreement, or any question arising thereunder, and the execution of a written contract incorporating any agreement reached if requested by either party, but such obligation does not compel either party to agree to a proposal or require the making of a concession: Provided, That where there is in effect a collective bargaining contract covering employees in an industry affecting commerce, the duty to bargain collectively shall terminate or modify such contract, unless the party desiring such termination or modification ---

(1) serves a written notice upon the other party to the contract of the proposed termination or modification



sixty days prior to the expiration date thereof, or in the event such contract contains no expiration date, sixty days prior to the time it is proposed to make such termination or modification;

(2) offers to meet and confer with the other party for the purpose of negotiating a new contract or a contract containing the proposed modifications;

(3) notifies the Federal Mediation and Conciliation Service within thirty days after such notice of the existence of a dispute, and simultaneously therewith notifies any State or Territorial agency established to mediate and conciliate disputes within the State or Territory where the dispute occurred, provided no agreement has been reached by that time; and

(4) continues in full force and effect, without resorting to strike or lock-out, all the terms and conditions of the existing contract for a period of sixty days after such notice is given or until the expiration date of such contract whichever occurs later.

Section 10. (e) The Board shall have power to petition any court of appeals of the United States,...within any circuit...wherein the unfair labor practice in question





occurred or wherein such person resides or transacts business, for the enforcement of such order and for appropriate temporary relief or restraining order, and shall file in the court the record in the proceedings, as provided in section 2112 of title 28, United States Code. Upon the filing of such petition, the court shall cause notice thereof to be served upon such person, and thereupon shall have jurisdiction of the proceeding and of the question determined therein, and shall have power to grant such temporary relief or restraining order as it deems just and proper, and to make and enter a decree enforcing, modifying, and enforcing as so modified, or setting aside in whole or in part the order of the Board. No objection that has not been urged before the Board, its member, agent, or agency, shall be considered by the court, unless the failure or neglect to urge such objection shall be excused because of extraordinary circumstances. The findings of the Board with respect to questions of fact if supported by substantial evidence on the record considered as a whole shall be conclusive. If either party shall apply to the court for leave to adduce additional





evidence and shall show to the satisfaction of the court that such additional evidence is material and that there were reasonable grounds for the failure to adduce such evidence in the hearing before the Board, its member, agent, or agency, the court may order such additional evidence to be taken before the Board, its member, agent, or agency, the court may order such additional evidence to be taken before the Board, its member, agent, or agency, and to be made a part of the record....Upon the filing of the record with it, the jurisdiction of the court shall be exclusive and its judgment and decree shall be final, except that the same shall be subject to review by the...Supreme Court of the United States upon writ of certiorari or certification as provided in section 1254 of title 28.

VERY LIGHT  
& GRAYISH



Section 24. GRIEVANCE PROCEDURE. When any employee covered under the terms of this agreement or when the Guild believes that the Employer has violated the express terms and conditions thereof, and that by reason of such violation his or its rights arising out of this agreement have been adversely affected, he or it, as the case may be, shall be required to follow the procedure hereinafter set forth in presenting the grievance and having the grievance investigated and the merits thereof determined.

First--The grievance in the first instance shall be presented to his immediate supervisor within fifteen (15) days of the alleged breach of the express terms and conditions of this agreement.

Second--If the immediate supervisor does not adjust the grievance to the complainant's satisfaction within three (3) days, such grievance shall then be presented in writing to the advertising director (in the case of the advertising department) or to the general manager or his designated representative (in the case of employees covered by Unit No. 3).

Third--If the grievance is not resolved to the satisfaction of the complainant by the advertising director or the general manager or his designated representative within three (3) days, the grievance may be submitted to final and binding arbitration by either party.

The Guild may designate a committee of its own choosing to take up with the Employer or his authorized agents matters not covered specifically under this agreement affecting the relations of employee and Employer; however, such grievance shall not be subject to arbitration.

Arbitration Procedure. Within forty-eight (48) hours after either party demands that the grievance be submitted to arbitration, duly appointed representatives of management and the Guild shall meet to determine the selection of an arbitrator, as follows:

Guild and management shall each submit two (2) names of possible arbitrators. These shall then select the fifth member of the panel. Then one (1) arbitrator shall be chosen as follows:

Each party may strike two (2) names from the panel and the remaining arbitrator shall serve in the case. All decisions of the arbitrator shall be limited expressly to the terms and

VERY LIGHT  
& GRAYISH





provisions of this agreement, and in no event may the terms and provisions of this agreement be altered, amended, or modified by the arbitrator. The arbitrator shall receive for his services such remuneration as, from time to time, shall be acceptable to him and agreed upon by the parties. All decisions of the arbitrator shall be in writing and a copy thereof shall be submitted to each of the parties hereto. All fees and expenses of the arbitrator shall be borne equally by the Guild and the Employer. Each party shall bear the expenses of the presentation of its own case.

The complainant in every hearing before the arbitrator shall present a prima facie case. In general, judicial rules of procedure shall be followed at every hearing, but the arbitrator need not follow the technical rules of evidence prevailing in a court of law or equity. The arbitrator shall make his decision in the light of the whole record and shall decide the case upon the weight of all substantial evidence presented.

A court reporter shall be present and record the proceedings. A transcript of the proceedings shall not be required in formal hearings except in cases where the parties agree it should be made. Either party may, at its own expense, furnish a transcript to the arbitrator without the consent of the other party; provided, however, that the other party shall be entitled to a copy of the transcript or access to the original transcript by agreeing to pay one-half (1/2) of the total transcript cost.

The parties may, by mutual agreement, request the arbitrator to conduct an informal hearing. An informal hearing shall mean a hearing without a reporter being present to transcribe the testimony of witnesses and arguments by representatives of the parties, but in all other respects the foregoing provisions of this subsection shall be applicable. In the case of an informal hearing, the decision of the arbitrator shall be limited to a written statement of his conclusion, without comment on the evidence or statement of the reasons therefor.

All decisions of the arbitrator under this subsection, including decisions following informal hearings, shall be final and binding upon the parties.



CERTIFICATE

I certify that, in connection with the preparation of this Brief, I have examined Rules 18 and 19 of the United States Court of Appeals for the Ninth Circuit, and that, in my opinion, the foregoing Brief is in full compliance with those rules.

  
LAURENCE H. SILBERMAN

Attorney for Respondent



In the United States Court of Appeals  
for the Ninth Circuit

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NATIONAL LABOR RELATIONS BOARD, PETITIONER

v.

HONOLULU STAR BULLETIN, INC., AND ADVERTISER  
PUBLISHING Co., LTD., d/b/a HAWAII NEWSPA-  
PER OPERATORS, RESPONDENT

---

On Petition for Enforcement of an Order of the  
National Labor Relations Board

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REPLY BRIEF FOR THE NATIONAL LABOR  
RELATIONS BOARD

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FILED

OCT 17 1966

WM. B. LUCK, CLERK

NOV 4 1966

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*Attorney,*  
*National Labor Relations Board.*

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**In the United States Court of Appeals  
for the Ninth Circuit**

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No. 20894

NATIONAL LABOR RELATIONS BOARD, PETITIONER

*v.*

HONOLULU STAR BULLETIN, INC., AND ADVERTISER  
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PER OPERATORS, RESPONDENT

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On Petition for Enforcement of an Order of the  
National Labor Relations Board

---

REPLY BRIEF FOR THE NATIONAL LABOR  
RELATIONS BOARD

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This reply brief is addressed to two contentions advanced in respondent's brief: (1) respondent's contention that the requirement that a waiver of the right to bargain about a subject must be "clear and unmistakable" does not apply where the collective bargaining agreement refers to that subject; and (2) respondent's contention that a provision in respondent's contract with the Union stating that "nothing in this agreement shall limit the right of the employer, at its discretion, to pay amounts in

excess of the salaries set forth above” insulates respondent from its statutory obligation to bargain about bonuses. Neither of these contentions is sound.

1. There is no justification for making inapplicable the requirement that a waiver be shown clearly and unmistakably where a party attempts to demonstrate such a waiver on the basis of contract language. On the contrary, the reason for the strict waiver rule is that it prevents strikes by avoiding the accumulation of resentment, dissatisfaction and frustration which preclusion of bargaining might arouse in employees where a dispute arises over a matter not settled in a contract. This rule, as shown in our opening brief (pp. 12-20), effectuates a basic objective of the Act—encouraging collective bargaining as a means of eliminating industrial strife. Where, as here, a term or condition of employment (bonuses) is not fixed by the contract, the Board’s view is that it must be settled by bargaining unless the Union or employer has clearly and unmistakably waived its right to bargain about this particular subject. The policy is equally applicable whether the party relies on contract language or contract negotiations to establish waiver.<sup>1</sup> And, contrary to re-

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<sup>1</sup> In *Tide Water Associated Oil Co.*, 85 NLRB 1096, the Board found that a “vague” management prerogative clause which made no specific reference to pension plans did not demonstrate that the union “clearly and unmistakably” waived its right to bargain about that subject. See also, *Inland Steel Company*, 77 NLRB 1, 14-15; *Proctor Manufacturing Corp.*, 131 NLRB 1166.

spondent's contention (Br. p. 17), the application of a strict waiver rule where the waiver is sought to be supported by contract language has been judicially approved. See *N.L.R.B. v. Otis Elevator Co.*, 208 F. 2d 176 (C.A. 2), where Judge Clark observed (*id.* at 178-179):

We do not doubt that there are areas where it is highly desirable that management have exclusive responsibility . . . But the general philosophy of the Act and the general desirability of joint participation and responsibility suggest that *any private reservations of power must be clearly described and delimited in the contract.* [Emphasis added.]

Accord, *Timkin Roller Bearing Co. v. N.L.R.B.*, 325 F. 2d 746, 751 (C.A. 6) (dictum). Cf. *N.L.R.B. v. Item Co.*, 220 F. 2d 936, 958-959 (C.A. 5).

2. To demonstrate that the Union has waived its right to bargain about bonuses, respondent relies heavily on a provision in the contract<sup>2</sup> stating:

Nothing in this agreement shall limit the right of the employer, at its discretion, to pay amounts in excess of the salary set forth above.

This argument is an afterthought, as respondent itself concedes.<sup>3</sup> Respondent did not refer to this

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<sup>2</sup> This provision appears as the last sentence on the last page (page 6) of Exhibit A, a comprehensive salary classification chart, which is appended to the 19-page collective bargaining agreement between the parties effective from October 1, 1963, to May 31, 1966 (G. C. Exh. 2).

<sup>3</sup> See resp. br. p. 20, n. 1.



provision of its contract during the Board proceedings. And Section 10(e) of the Act provides that “no objection that has not been urged before the Board, its member, agent, or agency shall be considered by the court, unless failure or neglect to urge such objection shall be excused because of extraordinary circumstances.”<sup>4</sup> Under well-settled law, therefore, respondent is foreclosed at this late date from now urging the above-quoted contract clause as a defense to its refusal to bargain. See, for example, *N.L.R.B. v. Ochoa Fertilizer Corp.*, 368 U.S. 318, 322; *N.L.R.B. v. District 50, United Mine Workers*, 355 U.S. 453, 463-464; *N.L.R.B. v. Seven-Up Bottling Co.*, 344 U.S. 344, 350; *Marshall Field & Co. v. N.L.R.B.*, 318 U.S. 253, 256; *N.L.R.B. v. Guistina Bros. Lumber Co.*, 253 F. 2d 371, 374 (C.A. 9); *Retail Clerks Int’l Ass’n v. N.L.R.B.*, — F. 2d — (C.A. D.C.), 62 LRRM 2837, 2841 (decided August 16, 1966). The rationale behind the enactment of Section 10(e) is that the orderly administration of the Act requires that the Board be apprised of all objections to the Trial Examiner’s findings and conclusions so that the Board may properly discharge its duty. *N.L.R.B. v. Pugh & Barr, Inc.*, 194 F. 2d 217, 220 (C.A. 4). Plainly, having failed to apprise the Board of its contention that the quoted provision constitutes a waiver, respondent is precluded from arguing here that the Board’s order should be denied enforcement on that ground.

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<sup>4</sup> Respondent has not come forward with any “extraordinary circumstances” to justify its failure to urge this contract provision before the Board.



Moreover, even if respondent could rely on the cited provision, that provision does not clearly and unmistakably evidence a waiver of the union's right to bargain concerning bonuses. Fairly read, that provision grants respondent the right to increase hourly or weekly salaries paid to employees, and has no bearing upon bonuses. Thus, the provision in question appears at the end of a six-page Appendix to the contract containing the rates to be paid employees in the job classifications set out in the Appendix.<sup>5</sup> Respondent's contention that this is too narrow an interpretation of the quoted provision because the word "amounts" could comprehend both bonuses and salaries (Br. pp. 20-22), demonstrates only that the language is not free from ambiguity. And in the absence of any record evidence demonstrating precisely what the parties intended when they inserted this provision at the termination of their negotiations, respondent's argument is insufficient to establish a clear and unmistakable waiver.<sup>6</sup>

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<sup>5</sup> Management's right to raise salaries unilaterally would thus complement the right of individual employees to bargain for salaries in excess of the minimum scale set forth in the contract. See Sec. 12(b) of G. C. Exh. 2. Such departures from "scale" wages are apparently not unusual in the newspaper business. See *Boston Herald-Traveler Corp. v. N.L.R.B.*, 223 F.2d 58, 59 (C.A. 1).

<sup>6</sup> The Board's order requiring respondent to bargain, upon request, concerning the formulation of new bonus plans does not, contrary to respondent (Br. pp. 26-29), run afoul of Section 8(d) of the Act. That section provides, in relevant part, that the duty to bargain collectively "shall not be construed as requiring either party to discuss or agree to any modification

## CONCLUSION

For the foregoing reasons and for the reasons set out in our opening brief, we respectfully submit that the Board's order should be enforced in full.

ARNOLD ORDMAN,  
*General Counsel,*

DOMINICK L. MANOLI,  
*Associate General Counsel,*

MARCEL MALLET-PREVOST,  
*Assistant General Counsel,*

GEORGE B. DRIESEN,  
*Attorney,*  
*National Labor Relations Board.*

October 1966.

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of the terms and conditions contained in a contract for a fixed period . . ." Thus, Section 8(d) excuses an employer from any duty to bargain during the contract term with respect to subjects expressly covered by such contract. *N.L.R.B. v. Jacobs Mfg. Co.*, 196 F. 2d 680 (C.A. 2); *Tide Water Associated Oil Co.*, *supra*, 85 NLRB 1096, 1098. Here, however, as noted, the subject of bonuses was neither explored during contract negotiations nor embodied in any clearly defined manner in the contract itself. Consequently, 8(d) poses no impediment to enforcement of the instant order.

IN THE UNITED STATES COURT OF APPEALS  
FOR THE NINTH CIRCUIT

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LEONARD LUNDGREN and EVELYN  
R. LUNDGREN,

Appellants,

v.

COMMISSIONER OF INTERNAL  
REVENUE,

Appellee.

FILED

SEP 16 1966

WM. B. LUCK, CLERK

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APPELLANTS' BRIEF

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Appeal from the Tax Court of the United States

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NOV 4 1966





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FOR THE NINTH CIRCUIT

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LEONARD LUNDGREN and EVELYN  
R. LUNDGREN,

Appellant,

v.

COMMISSIONER OF INTERNAL  
REVENUE,

Appellee.

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APPELLANTS' BRIEF

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Appeal from the Tax Court of the United States

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STATEMENT OF JURISDICTION

This is an appeal from a decision of the Tax Court of the United States affirming a determination of the Commissioner of Internal Revenue which asserts a \$25,040.01 Federal income tax deficiency against petitioners for the calendar year 1961 rather than allowing a \$20,192.40 refund claimed by petitioner. Such decision of the Tax Court also nullifies a refund claim filed by petitioner for 1958 attributable to an operating loss carried back from 1961. If petitioners are entitled to a 1961 business bad debt deduction in the amount of \$129,000, there is no deficiency for 1961, and the refunds will be allowed as claimed.



Appellate jurisdiction and the venue are granted this Court by 26 U.S.C.A., Sec. 7482(a) and 7482(b)(1). The Tax Court had the jurisdiction by virtue of 26 U.S.C.A., Sec. 7442.

#### STATEMENT OF THE CASE

Leonard Lundgren and Evelyn R. Lundgren, husband and wife, are residents of Oregon. Evelyn R. Lundgren is a party to the proceedings only because she filed a joint income tax return with Leonard Lundgren.

Petitioners are entitled to deduct the \$129,000 from ordinary income under the bad debt provisions of Sec. 166, provided the debt escapes classification as a nonbusiness debt. Sec. 166 (d) (2) defines a nonbusiness debt as follows:

"...the term 'nonbusiness debt' means a debt other than -

- (A) a debt created or acquired (as the case may be) in connection with a trade or business of the taxpayer; or
- (B) a debt the loss from the worthlessness of which is incurred in the taxpayer's trade or business."

The Tax Court held the advances of \$144,968.55 were "nonbusiness debts", and the Tax Court expressed doubt as to whether the advances constituted genuine indebtedness as contrasted to equity capital. There is no controversy concerning the facts set forth below. They are either direct, or substantially direct, quotations from the stipulation and Tax Court findings, or are based upon uncontradicted testimony. The issues solely relate to the conclusions which should be drawn from the uncontested facts.





The transcript of the record consists of two volumes.

Volume I containing the stipulation of the parties and the Tax Court's memorandum findings of fact and opinion is herein referred to as "R". Volume II containing the report of the proceedings before the Tax Court is herein referred to as "Tr", and has been corrected by stipulation (R 66) to delete the term "depreciation" and substitute the term "appreciation" on pages 24, 29, 32, 33, 34 and 49. All the exhibits are joint exhibits of the parties admitted under the stipulation.

Leonard Lundgren (hereinafter called "Petitioner") has been engaged in the timber and lumber manufacturing business during his adult life. He has conducted this business through proprietorships, partnerships and corporations (R 17-18). One of the corporations is RushMore Lumber Company a South Dakota corporation (herein called "RushMore"). Petitioner advanced sums aggregating \$144,968.55 to RushMore and in 1961 Petitioner charged off as worthless \$129,000 of such \$144,968.55. It is stipulated that if the \$144,968.55 in advances represent indebtedness rather than equity capital, the advances became worthless during 1961 to the extent of \$129,000 (R 18-19).

Prior to the formation of RushMore, Petitioner carried on businesses under the name of Leonard Lundgren Lumber Company, a partnership consisting of Petitioner, his brother, Raymond B. Lundgren, and Orville A. Young (R 19). The partnership was formed in 1951, and prior thereto Petitioner conducted a lumber manufacturing and sales business as a sole proprietorship in and around Bend, Oregon (R 32).





Under an agreement dated February 15, 1956 (Exh 2-B), all of the assets of the partnership, Leonard Lundgren Lumber Company, were transferred to two corporations. The major portion of the partnership assets (subject to all the liabilities) were transferred to Lelco, Inc.; and the balance of the partnership assets consisting of a portable sawmill and related property were transferred to RushMore for \$100,000 aggregate par value of RushMore common stock. The RushMore stock (as well as the Lelco, Inc. stock) was issued to the partners in proportion to their partnership interests: Leonard Lundgren 70%, Raymond B. Lundgren 20% and Orville A. Young 10% (R 19). The partnership assets transferred to RushMore for the \$100,000 in common stock were worth \$100,000.<sup>1</sup>

Immediately after transfer of the portable sawmill and related assets to RushMore in exchange for \$100,000 of stock, RushMore received an additional \$25,000 in cash from the sale of 25,000 shares of capital stock (R 21-22). This gave RushMore \$125,000 in capital stock owned as follows:

	<u>No. of Shares \$1.00 per Share</u>	<u>Percentage of Ownership</u>
Leonard and Evelyn Lundgren	74,500	59.6%
Raymond L. Lundgren	20,000	16 %
Orville A. Young	11,000	8.8%
Others	19,500	15.6%
Total	<u>125,000</u>	

<sup>1</sup> Prior to the Tax Court hearing, the Commissioner questioned whether the assets transferred to RushMore were worth \$100,000. Consequently, many of the stipulated facts and much of the evidence were directed to this valuation question. In his Tax Court brief, the Commissioner did not question the \$100,000 valuation or press a "thin incorporation" contention. It is assumed that the Commissioner will not question the \$100,000 valuation on this appeal, so facts relating to the \$100,000 valuation are not presented or discussed herein.



In 1959, RushMore acquired 9,000 shares of stock from certain of the "others" which acquisition increased the percentage interest of the taxpayer and his wife to 65.35%. There have been no subsequent changes in this stock ownership (R 21-22).

The lumber manufacturing activities of the partnership and predecessor proprietorship took place in Oregon. Lelco, Inc. took over and continued the Oregon operations of the partnership, minus the portable sawmill and related assets. The portable sawmill and related assets transferred to RushMore were moved from Oregon to the plant site of RushMore in South Dakota (Tr38-39). The South Dakota venture of RushMore was motivated by Petitioner's belief that a good opportunity existed for the purchase of timber in South Dakota and the resale of the timber by Petitioner to RushMore at a profit. This opportunity was believed to exist because of the lack of competition in the bidding for United States Forest Service timber available in the South Dakota area (Tr 54).

To obtain funds for improving the sawmill, installing dry kilns and a planing mill at its South Dakota site, RushMore filed an application (Ex 5-E) dated July 27, 1956 with the Small Business Administration for a loan of \$250,000, repayable over a ten-year period. The SBA loan application contained a number of exhibits. Exhibit 5 to the application was a forecast of cash receipts and disbursements of RushMore for the period July 1, 1956 to June 30, 1957. This forecast showed temporary advances of \$115,859 to be made by Petitioner during July, August and September of 1956 which advances (according to the forecast) would be repaid during October, November and







December, 1956, and January, 1957. The forecast further specified the repayment during February, March and April, 1957 of \$15,000 in notes owed to Lelco, Inc. and \$29,000 in notes owed to Petitioner for advances previously made.

The SBA granted the loan of \$250,000 under conditions set forth in a loan authorization. The loan authorization did not approve the requested ten-year repayment term, or approve the projected repayment of Petitioner's \$144,859 in advances by May, 1957. Rather, the SBA required repayment of the SBA loan in six years (rather than ten), and required that Petitioner's advances of \$144,859 be subordinated to the SBA loan through the execution of a standby agreement (Ex 15-O).

Conditions of the SBA loan authorization were met, and the SBA loan was evidenced by a promissory note for \$250,000 dated September 21, 1956 (Ex 9-I) payable in installments of \$4,500 per month which included interest at the rate of 6% per annum, with complete payment being due on or before six years from September 21, 1956. The SBA note was secured by a first mortgage (Ex 10-J), and Petitioner guaranteed repayment (Ex 13-M). The loan agreement (Ex 12-L) prohibited RushMore from paying dividends and from making distributions upon or in redemption of its stock.

Advances of \$115,968.55 were made by Petitioner pursuant to the SBA loan authorization in addition to the original \$29,000. The aggregate advances of \$144,968.55 were evidenced by unsecured demand promissory notes bearing 4% interest. Copies of these notes are attached to Exhibit 15-O, the standby agreement executed by Petitioner. The SBA loan application (Ex 5-E) and the



SBA loan authorization (Ex 7-G) referred to Petitioner's advances as loans. The standby agreement (Ex 15-O) refers to Petitioner's advances as amounts owing to Petitioner evidenced by attached copies of the \$144,968.55 in notes. A pro forma balance sheet prepared by a representative of the SBA (Ex 6-F, Tr 98) showed Petitioner's advances as liabilities. Nowhere and at no time did Petitioner, the SBA, or anyone else, refer to or regard Petitioner's advances as equity capital or as anything other than debt obligations. The notes were not subordinated by Petitioner to any creditor other than the SBA.

Petitioner thought RushMore had ample equity capital based upon his past mode of operation and past experience in Oregon (Tr 21). The RushMore operation did not commence generating profits with the same facility in South Dakota as had Petitioner's operations in Oregon. What worked out well in Oregon did not work out so well in South Dakota (Tr 25-26). After encountering difficulties in 1956, 1957 and 1958, things began to iron out in 1959 and there was a climb in the lumber market. The fiscal year ended March 31, 1960 was RushMore's best year (Tr 65). Things were going much better in 1960 when, on June 28, 1960, fire destroyed the sawmill and certain related facilities (Tr 65 and R 28). RushMore received insurance proceeds of \$124,307.24, for the destroyed assets (R 29). The SBA required that the insurance proceeds be applied against the first mortgage indebtedness (R 29). The SBA was paid in full as shown on Exhibit 28-AB (R 29). The lumber market took a drop in the last quarter of 1960 (Tr 65-66). RushMore never resumed operations after the fire (R 29).





Petitioner never sold stock in a corporation which he formed or caused to be formed or in a corporation controlled by him (R 35). The economic benefits which Petitioner sought from his corporations were compensation for services rendered and/or profit from the sale of timber by Petitioner to the corporations. Petitioner realized both of these economic benefits from Lelco, Inc. Over a period of years, Petitioner sold large quantities of timber to the partnership predecessor of Lelco, Inc. and such timber sales were continued to Lelco, Inc. after its formation (R 47). The sales were in Oregon and the business was profitable (R 52). Petitioner received compensation from Lelco, Inc. for services performed as president (R 47). Petitioner also received a salary from Lundgren Sales Corporation (R 47), a corporation formed in 1952, owned by Petitioner and his wife, which sold lumber produced by the partnership until the incorporation of Lelco, Inc. in 1956, and thereafter sold lumber produced by Lelco, Inc. and RushMore. The compensation paid Petitioner by Lelco, Inc. and Lundgren Sales Corporation is set forth on Exhibit 45-AS.

Petitioner did not form RushMore with the intention of selling the stock at a profit or receive any dividends (R 35-36). Petitioner expected to receive the same economic benefits from RushMore as he received from Lelco, Inc. and Lundgren Sales Corporation, - compensation for services rendered and profits from the sale of timber (Tr24, 34). Realization of these economic benefits was suspended by restrictions imposed as conditions to the SBA loan which restrictions and their impact are related in the next two paragraphs.





The SBA loan agreement (Ex 12-E) provided that no compensation of any kind shall be paid to any officers of RushMore without prior written approval of the SBA. This restriction did not prevent Petitioner from being an officer of RushMore or performing services for it. Petitioner was president of RushMore from the time of its formation (Ex 5-E), and Petitioner performed services for RushMore in addition to the services performed for Lelco, Inc. and Lundgren Sales Corporation (R 47). Petitioner intended to take a salary from RushMore after the SBA restriction was removed. (Tr 34).

In anticipation of RushMore's timber needs, Petitioner acquired two Forest Service timber contracts entitling him to purchase approximately 28,000,000 feet of timber in the Black Hills area of South Dakota. Petitioner informed RushMore that he would make this timber available if and when needed by RushMore (Ex 6 to Ex 5-E). It was Petitioner's intention to sell such timber and subsequently acquired timber, to RushMore at the market price when delivered following the pattern employed in the case of the predecessor partnership and Lelco, Inc. which would give Petitioner a profit in the amount of any appreciation in timber values between the date of acquisition and date of sale to RushMore (Tr 23-24, 54). Carrying out of this intention was precluded by an SBA loan requirement that Petitioner sell at his cost the timber covered by the two Forest Service contracts (R 47) and that Petitioner sell any subsequently acquired timber to RushMore at cost (R 52). Because of this SBA restriction, Petitioner had RushMore take



subsequent Forest Service timber contracts in RushMore's own name which saved the paper work of transferring the timber from Petitioner to RushMore at cost (Tr 33-34), but this did not represent a deviation from Petitioner's intention to sell timber at a profit after elimination of the SBA restrictions (Tr 24, 34, 54). It was necessary for Petitioner to become personally liable on the required performance bonds when RushMore took Forest Service timber contracts in its own name (Tr 42, R 44).

The Commissioner presented no witnesses, and no evidence other than the joint exhibits.





Petitioners contend that the Tax Court of the United States erred as follows in denying a business bad debt deduction to Petitioners in the amount of \$129,000 for the year 1961:

1. In failing to conclude that Petitioner's activities connected with RushMore constituted the conduct of a trade or business.

2. In failing to conclude that a proximate relationship existed between:

- (i) Petitioner's advances of \$144,968.55 to RushMore; and

- (ii) Petitioner's trade or business activities connected with RushMore.

3. In failing to conclude that a proximate relationship existed between:

- (i) Petitioner's advances of \$144,968.55 to RushMore; and

- (ii) Petitioner's trades and businesses activities connected with business entities in general or connected with Lelco, Inc. and Lundgren Sales Corporation in particular;

the Tax Court having recognized that Petitioner's activities in regard to business entities in general, and Lelco, Inc. and Lundgren Sales Corporation in particular, constituted the conduct of trades or businesses.

4. In expressing doubts as to whether Petitioner's advances of \$144,968.55 created a genuine indebtedness rather than equity contributions.



Trade or Business -  
First Specification of Error

Petitioner contends that his activities connected with RushMore constituted the conduct of two trades or businesses, -

(i) the trade or business of performing services for RushMore as an officer and employee; and

(ii) the trade or business of selling timber to RushMore.

The Tax Court bases its conclusion that Petitioner was not engaged in the trade or business of performing services for RushMore solely upon the fact that Petitioner never *received a salary* from RushMore, the payment of a salary being precluded by SBA first mortgage loan restrictions. The Tax Court bases its conclusion that Petitioner was not engaged in the trade or business of selling timber to RushMore solely upon the fact that Petitioner never sold timber to RushMore *at a profit*, the SBA loan conditions requiring that Petitioner sell timber to RushMore at cost. The conclusion of the Tax Court that there must be some actual income realization before activities warrant recognition as the conduct of a trade or business conflicts with the opinion of this Court in Hirsch v. Commissioner, 315 F.2d 731 (9th Cir. 1963). Under the doctrine of Hirsch v. Commissioner, supra, an activity constitutes the conduct of a trade or business when the dominant intent behind the activity is to *ultimately* make a profit from the activities. Immediate profit is not necessary.





The Tax Court relies upon a quotation from Whipple v. Commissioner, 373 U.S. 193 at 204 (1963) that the taxpayer had not collected a salary and was not owed one. When the Tax Court's quotation from Whipple is viewed in the full context of the Supreme Court's opinion, there is no conflict with Hirsch. Rather, the approaches and conclusions of Whipple and Hirsch are most compatible, both applying similar tests. Both the approaches of Whipple and Hirsch reach the conclusion that activity of a taxpayer connected with his controlled corporation does not constitute the conduct of a trade or business when the sole or primary monetary remuneration sought from the activity is appreciation in value of the stock and dividends upon the stock, - the return of an investor. Expectation of an investor's return did not furnish the primary economic motivation for Petitioner's activities connected with RushMore. As stipulated and found by the Tax Court, Petitioner did not form RushMore with the intention of selling the stock at a profit or receiving any dividends. This confirms Petitioner's corroborated testimony that he was motivated by the expectation of ultimately receiving when permitted by elimination of the SBA loan restrictions:

(i) salary for services rendered to RushMore;  
and

(ii) profit from the sale of timber to RushMore.





Remoteness of the anticipated remuneration becomes a factor only when it casts doubt upon the actuality of the expectation. Everything is motivated by something and the Commissioner has not suggested any motivation other than the abovementioned expectations of Petitioner.

Proximate Relationship -  
Second and Third  
Specifications of Error

A proximate relationship exists between a loan and the economic motivation for the loan. In most cases involving loans by stockholders to controlled corporations, the problem is determining the priority between: (i) trade or business motivation, and (ii) motivation attributable to stock investment. Motivation attributable to stock investment is eliminated by the stipulation and Tax Court finding that Petitioner did not form RushMore with the intention of selling the stock at a profit or receiving any dividends. With this nonqualifying motivation eliminated, the only motivating candidate is compensation for services rendered and the gain from the sale of timber which Petitioner expected to receive after elimination of the SBA loan restrictions. Where loans are motivated by trade or business considerations with no competing, nonqualifying motivation, the loans are obviously "created in connection with a trade or business of the taxpayer". Nothing more is required to satisfy the nonbusiness debt exclusion under Sec. 166(d)(2)(A).

The preceding argument (encompassing the first and



second specifications of error) primarily concerns the activities of Petitioner connected with RushMore. Petitioner was also active in connection with two other corporations, Lelco, Inc. and Lundgren Sales Corporation. The Tax Court found that Petitioner was engaged in the trade or business of rendering services to Lelco, Inc. and Lundgren Sales Corporation as officer and employee, and the Tax Court found Petitioner was engaged in the trade or business of selling timber to Lelco, Inc. The scope of Petitioner's trade or business activities should be expressed in general terms, - as rendering services as an officer and employee of corporations, and selling timber to entities for profit. When expressed in these general terms, without limitation to any particular corporation or entity, Petitioner's activities in connection with RushMore are just as much within the scope of such trades or businesses as Petitioner's activities in connection with Lelco, Inc. and Lundgren Sales Corporation. Creation of a new corporate employer and creation of a new purchaser for timber augments and expands the trades or businesses of rendering services to corporations and selling timber to entities.

Even if the scope of the trades or businesses in which Petitioner is engaged is limited to rendering services as an officer and employee of Lelco, Inc. and Lundgren Sales Corporation, and limited to the selling of timber to Lelco, Inc., there is a proximate relationship between such trades or businesses and the loans to RushMore.





## Debt vs. Equity

Intent has always been the touchstone of this Court's approach to the debt vs. equity issue. When, as here, the transaction is highly documented and the instruments involved are conventional in form with no ambiguities, the best evidence of the intent of the parties is the manifestation thereof contained in the instruments, at least where no conflicting intent is disclosed by the conduct of the parties.

The promissory notes representing Petitioner's advances were conventional in form and subordinated only to the SBA first mortgage. This furnishes strong, if not conclusive, evidence of intent to create an indebtedness. Other documentation likewise supports debt recognition. There is no conflicting conduct of the parties.

Ignoring all the individualized manifestation of intent, the Tax Court applies objective standards of whether an outside source would have made the advances, and whether the advances were put at the risk of the business to a greater extent than the Tax Court deems proper under its version of prudent corporate financing. Such approach of the Tax Court is a warmed over version of the thesis employed in John S. Taft, 20 CCH Tax Ct. Mem. 1135 (1961), which this Court held to be clearly erroneous in Taft v. Commissioner, 314 F.2d 620 (9th Cir. 1963).



## FIRST SPECIFICATION OF ERROR

*The Tax Court erred in failing to conclude that Petitioner's activities connected with Rushmore constituted the conduct of a trade or business.*

### ARGUMENT

Although the Tax Court found that Petitioner was engaged in the trade or business of rendering services to Lelco, Inc. and Lundgren Sales Corporation as officer and employee (R 50, 52), and engaged in the trade or business of selling timber to Lelco, Inc. and the predecessor partnership (R 50, 52), the Tax Court held that Petitioner

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2 The following cases cited in Petitioner's Tax Court brief support the proposition that the performance of services constitutes the conduct of a trade or business: Folker v. Johnson, 230 F.2d 906 at 909 (C.A. 2d Cir. 1956); Pierce v. United States, 254 F.2d 885 (C.A. 9th Cir. 1958), 58-1 USTC para 9470; Trent v. Commissioner, 291 F.2d 669 (C.A. 2d Cir. 1961), 61-2 USTC para 9506.

3 In Jantzer v. Commissioner, 284 F.2d 348 (C.A. 9th Cir. 1960) affg. 32 T.C. 161 (1959) this court affirmed the conclusion of the Tax Court that timber was held primarily for sale to customers in the ordinary course of trade or business where timber from several tracts was sold by a partnership to a controlled corporation. If timber is held primarily for sale to customers in the ordinary course of business, the holder is engaged in the trade or business of selling timber. The fact that the seller may claim capital gain on timber sales under Sec. 631(b) does not affect the conclusion that he is engaged in a trade or business. Regulation 1.631-2(a) expressly relates that capital gain is recognized under Sec. 631(b) regardless of whether timber is property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business.





was not engaged in any such trades or businesses so far as RushMore was concerned (R 52). This holding was made by the Tax Court despite the following findings in regard to Petitioner's activities and expectations connected with RushMore:

Petitioner performed services for RushMore (as well as Lelco, Inc. and Lundgren Sales Corporation), and Petitioner would have received a salary from RushMore if it were not for the SBA restriction prohibiting the payment of salaries to officers (R 47).

Petitioner sold two timber sales contracts to RushMore at cost (R 43). These contracts were sold to RushMore at cost (rather than the timber being sold to RushMore at a profit) because of a condition in the SBA loan authorization (R 47). Petitioner hoped to sell timber to RushMore at a profit after retirement of the SBA loan and elimination of the SBA restriction (R 52).

The Tax Court bases its conclusion that Petitioner's activities connected with RushMore did not constitute the conduct of a trade or business solely upon the fact that Petitioner never received a salary from RushMore and never sold timber to RushMore at a profit. The question, then, is whether there must be some actual realization of the motivating monetary remuneration before activities warrant recognition as the conduct of a trade or business? A similar





question was faced by this Court in Hirsch v. Commissioner, 315 F.2d 731 (9th Cir. 1963).

The issue in Hirsch v. Commissioner, supra, was whether executive activities of a corporate officer amounted to the conduct of a trade or business so as to permit deduction of claimed business expenses and deduction of a claimed bad debt. No compensation had actually been received by the executive for his activities. If failure to receive monetary remuneration precludes activities from being considered the conduct of a trade or business, this Court would have so stated in Hirsch. Instead, the following quotation from Hirsch makes it clear that actual realization of the anticipated monetary remuneration is not required if the dominant intent is to ultimately make a profit or income from the activities cited as constituting the conduct of a trade or business (315 F.2d 731 at 736):

"...While the expectation of the taxpayer need not be reasonable, and *immediate profit from the business is not necessary*, nevertheless, the basic and dominant intent behind the taxpayer's activities, out of which the claimed expenses or debts were incurred, must be *ultimately* to make a profit or income from those very same activities." (emphasis added).

As authority for its holding that the services performed by Petitioner as president of RushMore did not constitute the conduct of a trade or business, the Tax Court relies upon the following quotation from Whipple v. Commissioner, 373 U.S. 193 at 204 (1963):



"...Nor need we consider or deal with those cases which hold that working as a corporate executive for a salary may be a trade or business, E.g., Trent v. Commissioner, 291 F.2d 669 (C.A. 2d Cir.). Petitioner made no such claim in either the Tax Court or the Court of Appeals and, in any event, the contention would be groundless on this record since *it was not shown that he has collected a salary from Mission Orange or that he was owed one.*" (Emphasis added).

Whipple v. Commissioner was decided by the Supreme Court in May, 1963 after Hirsch v. Commissioner was decided by this Court in March, 1963. Does the above quotation from Whipple overrule the above quotation from Hirsch?

When the Tax Court's quotation from Whipple is viewed in the full context of the Supreme Court's opinion, there is no conflict with Hirsch. Rather, the approaches and conclusions of Whipple and Hirsch are most compatible, both applying similar tests. The issue in Whipple was whether the devotion of substantial time and energies by a controlling stockholder to the affairs of his corporation for the *purpose of receiving an investor's return*, amounts to the conduct of a trade or business. After reviewing the line of cases which holds that investing is not a trade or business, no matter how extensive the activity, the Supreme Court concluded in Whipple that the devotion of time and energies to the affairs of a controlled corporation, no matter how extensive, is not, in and of itself and without more, a trade or business *when an investor's return is the only monetary benefit sought to be derived from*





the corporation as a result of the devoted time and energies.

If the taxpayer in Whipple had contended that an economic motivation was the expectation of compensation for services rendered, such would have conflicted with the basic proposition of Whipple that an investor's return was the only monetary remuneration the taxpayer sought from the corporation as the reward for his devotion of time and energies to its affairs. In the quotation from Whipple cited by the Tax Court, the Supreme Court merely assured itself that the status of the record, rather than oversight, accounted for the taxpayer's failure to make a contention which would have conflicted with the basic proposition. The Supreme Court did not discuss whether the expectation of future compensation for services rendered would have been the equivalent of present compensation actually received. This is understandable because a Court seldom considers the materiality of every eventuality when

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4 The key quotation from Whipple reads as follows (373 U.S. 19 at 202): "Devoting one's time and energies to the affairs of a corporation is not of itself, and *without more* a trade or business of the person so engaged. Though such activities may produce income, profit or gain in the form of dividends or enhancement in the value of an investment, this return is distinctive to the process of investing and is generated by the successful operation of the corporation's business as distinguished from the trade or business of the taxpayer himself. *When the only return is that of an investor*, the taxpayer has not satisfied his burden of demonstrating that he is engaged in a trade or business since investing is not a trade or business and the return to the taxpayer, though substantially the product of his services, legally arises not from his own trade or business but from that of the corporation." (emphasis added)



rejecting the applicability of a contention which a party did not make. Suppose the record in Whipple had established that the economic benefit which the controlling stockholder expected to derive from his activities connected with the corporation were salary for services rendered and profit from the sale of timber to the corporation?

That Hirsch v. Commissioner still represents the law on the subject is confirmed by LaMont v. Commissioner of Internal Revenue (2nd Cir. 1964) 339 F.2d 377. Decided more than an year after the Supreme Court's decision in Whipple, LaMont v. Commissioner cites Hirsch as follows (339 F.2d 377 at 380):

"While the expectation of profit need not be a reasonable one, and the business need not realize an immediate profit, the activities must be entered into and carried on in good faith for the purpose of making a profit. Hirsch v. Commissioner, supra; Doggett v. Burnett, 62 App. D.C. 103, 65 F.2d 191 (1933)."

Although actual receipt of monetary benefit is not necessary for activities to constitute the conduct of a trade or business, the basic and dominant intent behind the taxpayer's activities must be ultimately to make a profit or income from the activities. In Hirsch, this Court sustained the conclusion of the Tax Court that the taxpayer's activities as corporate executive were not motivated by the expectation of compensation when the business became successful. Rather, the Tax Court found the executive activities were motivated by the taxpayer's extensive bond holdings in the subject corporation, and by the taxpayer's desire of having a supplemental excuse for being in Las Vegas where activities on behalf of the corporation carried the taxpayer.





When a controlling stockholder devotes extensive time and energies to the affairs of his corporation, there may be a natural inference that the monetary remuneration which he expects to derive therefrom is the return of an investor. The return of an investor is gain from disposition of the corporate stock and the receipt of dividends upon the stock. As held by the Supreme Court in Whipple v. Commissioner, supra, if an investor's return is the only monetary benefit sought to be derived from a corporation as the result of the devotion of time and energies to the corporate affairs, such devotion of time and energies is not the conduct of a trade or business because investing is not a trade or business. The same conclusion is reached under the approach of Hirsch. Where an investor's return furnishes the economic motivation for executive activities, the basic intent is not profit or income to be derived directly from such activities through compensation for services rendered. Rather, the basic intent under such an investor's motivation is to derive an indirect benefit through enhancement in value of the stock or dividends thereon.

Expectation of an investor's return in the form of dividends and gain from disposition of RushMore stock did not furnish the dominant economic motivation for Petitioner's activities connected with RushMore. As stipulated and found by the Tax Court, Petitioner had been engaged in the lumber and manufacturing business during his adult life, and in the course thereof had organized and held substantial stockholdings in corporations (R 38). If an investor's return were the monetary benefit Petitioner sought from his corporations, he





undoubtedly would have realized such return sometime during his lifetime. Yet, as further stipulated and found by the Tax Court, Petitioner never sold stock in a corporation controlled by him, and he never received a dividend from any such corporation (R 48). These background facts differ from those in Whipple, where the Supreme Court related that within a three-year period the taxpayer was an original incorporator of seven corporations, and sold his interest in these corporations along with his equity in five others. Understandably, the Court in Whipple found an investor's return was the only return sought by the taxpayer from his activities connected with the corporate borrower. Such facts in Whipple contrasts with the following quotation from the stipulation, incorporated in the Tax Court findings (R 35-36, 48):

"...Petitioner did not form RushMore with the intention of selling the stock at a profit or receiving any dividends..."

Selling stock at a profit and receiving dividends are the only ways of deriving monetary remuneration from a corporate stock investment. In view of this stipulation, an investor's return was not the primary, much less the only monetary remuneration which Petitioner hoped to derive from RushMore.

Under the doctrine of Hirsch v. Commissioner, personal activity need not generate an immediate profit to constitute the conduct of a trade or business, provided the basic dominant intent is the ultimate realization of gain or income from the activity. In other words, the activity cited as constituting the conduct of a trade or business must be motivated by the ultimate realization of gain or income directly from the



activities. Negation of an investor's return as the economic benefit sought by Petitioner supports Petitioner's testimony that he was motivated by the expectation of ultimately receiving when permitted by elimination of the SBA restrictions:

- (i) salary for services rendered to RushMore (Tr 34), and
- (ii) profit from the sale of timber to RushMore (Tr 24, 34, 54).

This testimony of Petitioner was corroborated (Tr 79-80, 99). No competing or altruistic motivation has been suggested by the Commissioner.

Hirsch v. Commissioner places no limitation upon how far in the future a person may look for the ultimate realization of the expected profit or income. Remoteness of the anticipated economic remuneration becomes a factor only when it casts doubt upon the actuality of the expectation. There is no room for doubting the actuality of the expectations in the instant case. As related in the preceding paragraph, uncontradicted and corroborated testimony establishes that Petitioner was motivated by the expectation of ultimately receiving compensation for services rendered to RushMore and profit from the sale of timber to RushMore, and the Commissioner has suggested no competing motivation. Certainly, actual realization of the motivating economic remuneration need not occur during such period of time as realization is precluded by first mortgage loan restrictions incident to the procurement of financing used for the installation of new facilities aimed at increasing the profit and income to be ultimately realized after elimination of the restrictions. Petitioner would not have caused RushMore to obtain the SBA loan imposing the





restrictions if he did not believe the sacrifice of immediate realization was justified by the expected increase in the ultimate realization.

While the SBA restrictions delayed the time when Petitioner could begin to reap the anticipated monetary benefits, the restrictions did not prevent Petitioner from performing services as an officer of RushMore or prevent Petitioner from engaging in timber transactions with RushMore. Petitioner was president of RushMore from the time of its formation (Ex 5-E), and Petitioner performed services for RushMore (R 47). Neither did the SBA restrictions preclude the Petitioner from engaging in timber transactions with RushMore. Petitioner acquired two Forest Service timber contracts covering 28,000,000 feet of timber and notified RushMore that he held this timber for purchase by RushMore as needed (R 23, Ex 6 to Ex 5-E). He intended to sell the timber to RushMore at a profit if appreciation in timber values justified a profit (Tr 23-24). However, the SBA required that Petitioner sell these two Forest Service contracts to RushMore at cost (R 47-48) and further required that any additional timber be sold by Petitioner to RushMore at cost (R 52). Subsequent Forest Service contracts were acquired in the name of RushMore to eliminate the paperwork of taking title in Petitioner's name and then selling the timber at cost to RushMore (Tr 33-34), but such practice would have been changed when warranted by prospective removal of the SBA restrictions (Tr 24). RushMore could not have acquired the subsequent Forest Service timber contracts in its own name if Petitioner had not personally furnished the required



performance bonds. In a very real sense, Petitioner supplied this additional timber to RushMore.

In the case of bad debts resulting from loans to a newly formed corporation, it is quite likely that a defaulting corporation will never have generated the monetary remuneration anticipated by the founder. A person who receives none of the monetary remuneration which motivated the creation of his corporation needs a tax break more than one who has enjoyed some of the economic fruits. Tax provisions should not be interpreted in a manner which denies their benefits to those who need them most.



## SECOND SPECIFICATION OF ERROR

*The Tax Court erred in failing to conclude that no proximate relationship existed between:*

*(i) Petitioner's advances of \$144,968.55 to RushMore; and*

*(ii) Petitioner's trade or business activities connected with RushMore.*

### ARGUMENT

Until the Internal Revenue Code of 1954, the only nonbusiness debt exclusion read:

"...a debt the loss from the worthlessness of which is incurred in the taxpayer's trade or business."

A body of case law developed the "proximate relationship" doctrine in determining whether the loss from the worthlessness of a debt was incurred in the taxpayer's trade or business. This nonbusiness exclusion is now paragraph (B) of Sec. 166(d)(2) of the 1954 Code. A new exclusion from the nonbusiness debt definition was added by the 1954 Code in the form of paragraph (A) to Sec. 166(d)(2) which reads:

"(A) a debt created or acquired (as the case may be) in connection with a trade or business of the taxpayer; or"

The phrase "in connection with" of paragraph (A) added by the 1954 Code is a looser term than "incurred in". Cases considering Sec. 166(d)(2) of the 1954 Code have applied the proximate relationship doctrine without specifically consider-





ing whether the degree of relationship is less exacting under paragraph (A) than under paragraph (B).

A proximate relationship exists between a loan and the economic motivation for the loan. This is confirmed by Weddle v. Commissioner (2nd Cir. 1963) 325 F.2d 849, the leading post-Whipple decision on the proximate relationship doctrine involving the business vs. nonbusiness characterization of loans made by stockholders to a controlled corporation. The question considered in Weddle was whether trade or business considerations must furnish the "primary" motivations, or whether it is sufficient that the debt be "significantly" motivated by the taxpayer's trade or business even though there is a nonqualifying motivation as well. Weddle held that "significant" trade or business motivation is enough.

In Weddle, as in most other cases involving loans by stockholders to controlled corporations, the difficulty arose from the competing, nonqualifying motivation attributable to the stock investment. In the case of loans made to an established corporation during a period of economic decline, the nonqualifying motivation is protection of the stock investment. In the case of loans to a new corporation during its formative stage, the nonqualifying motivation is potential dividends and potential gain to be realized from enhanced stock values. Protection of investment was the motivation in Weddle, and the Tax Court expressed the problem as follows (39 T.C. 493 at 496 and 498):



"During the years in issue, petitioner wore two hats, one as president and general manager of the company for which she received a substantial salary, and two as a major shareholder of a corporation with her daughter owning the remaining stock. The question which we have before us is to determine what hat petitioner wore the day she endorsed the corporate notes which she subsequently was called upon to partially pay."

.....

"...In the absence, however, of scales sufficiently sensitive to be able to ascertain the exact percentage of motivations which impelled their respective actions, we look to the main and dominant reason for their actions. In the instant case, petitioner has failed to establish that her dominant reason was to continue her business of being president and general manager rather than to protect her investment."

What if a stipulation of the parties in Weddle had eliminated protection of investment as a motivation for the loans? Then the taxpayer would have been wearing but one hat.

Petitioner did not advance \$144,968.55 to RushMore without economic motivation. To use the terminology of Weddle, the economic motivation may be a qualifying or nonqualifying one. The stipulation and the Tax Court findings eliminate the receipt of dividends and realization of gain from stock investment as a nonqualifying motivation for Petitioner's loans. Sometimes the interest rate may motivate a loan. This is a nonqualifying motivation unless the lender is in the loan business. Petitioner's loans were not motivated by the interest rate which was only 4% in contrast to the 6% rate on the SBA mortgage. With dividends, gain from stock investment and interest rate eliminated as motivation candidates, what remains? No economic benefits have been suggested as motivation candidates other than compensation for services rendered as president





and gain from the sale of timber, both necessitating the conduct of a trade or business for attainment, and both being the subject of extensive activities on the part of Petitioner. These trades or business motivations stand alone without competition from nonqualifying motivations. This supplies the necessary proximate relationship, whether the motivation need be "primary" or merely "significant". Where loans are motivated by trade or business considerations with no competing, nonqualifying motivations, the loans are obviously "created in connection with a trade or business of the taxpayer". Nothing more is required to satisfy the nonbusiness debt exclusion under Sec. 166(d)(2)(A).

In Whipple, the Supreme Court stated that an employee, to establish a proximate relationship between a loan and the business of being an employee, must furnish proof "that the loan was necessary to keep his job or was otherwise proximately related to maintaining his trade or business as an employee". 373 U.S. 193 at 204. The Tax Court cites this statement and observes that Petitioner's stock control precludes any contention he was required to loan RushMore money to keep his position (R 51). The Tax Court ignores the Supreme Court's concluding phrase "or otherwise proximately related to maintaining his trade or business as an employee". As aptly observed in Weddle (325 F.2d 849 at 851):

"That Mrs. Weddle, unlike Trent, did not have to fear being fired by a superior, is also not at all conclusive as to what she was trying to protect; she would have been fired soon enough if the company had to cease operations through inability to obtain credit - as she was when it ultimately did."



Petitioner's loans were an intricate part of the formation and financing of RushMore. Without the financing, RushMore would have been unable to employ Petitioner as president. Not only did the loans make the job of president possible, but the loans, together with the SBA loans, expanded the scope of the presidency through the enlargement of operations resulting from the addition of the planing mill and dry kilns to augment the sawmill.

Petitioner's loans were likewise proximately related to the business of selling timber. Without the financing augmented by the loans, there was no chance that RushMore could have become a purchaser of timber from Petitioner. Not only did the loans make possible the creation of RushMore as a purchaser, but the loans, together with the SBA loan, increased the quantities of timber which RushMore could purchase through the enlarged operations.





### THIRD SPECIFICATION OF ERROR

*The Tax Court erred in failing to conclude that a proximate relationship existed between:*

*(i) Petitioner's advances of \$144,968.55 to RushMore; and*

*(ii) Petitioner's trades and businesses activities connected with business entities in general or connected with Lelco, Inc. and Lundgren Sales Corporation in particular;*

*the Tax Court having recognized that Petitioner's activities in regard to business entities in general, and Lelco, Inc. and Lundgren Sales Corporation in particular, constituted the conduct of trades or businesses.*

#### ARGUMENT

The argument under the preceding specifications of error primarily considered the activities of Petitioner connected with RushMore. Such activities did not comprise the whole of Petitioner's economic life. Petitioner's general occupational background and activities are summarized in the following quotation from the stipulation incorporated in the Tax Court findings (R 17-18, 38):

"Petitioner has been engaged in the timber and lumber manufacturing business during his adult life. He has conducted this business through partnerships and individual proprietorships. He has also organized, has been and now is an officer of, and has held and now holds substantial stock-





holdings in corporations engaged in the timber and lumber manufacturing and sales business."

It was only natural that such extensive economic endeavors should involve the conduct of some trade or business, and the Tax Court so held in the following key sentence of its opinion (R 50):

"We agree with petitioner when he states that he was carrying on a trade or business within the meaning of section 166(d)(2), Internal Revenue Code of 1954 (1) by rendering services to corporations as an officer and employee of corporations, (2) by selling timber to various entities for profit, and (3) by operating a sawmill and manufacturing lumber at his plant in Sisters, Oregon."

In the above quotation, the Tax Court correctly expresses the scope of Petitioner's trade or business. As there related, Petitioner was carrying on a trade or business by rendering services to corporations as an officer and employee of corporations, and by selling timber to various entities for profit. When explained in these general terms without limitation to any particular corporation or entity, Petitioner's activities in connection with RushMore are just as much within the scope of such trades or businesses as Petitioner's activities in connection with Lelco, Inc. and Lundgren Sales Corporation. The Tax Court erred in subsequent portions of its opinion which limit the above correct statement of Petitioner's trade or business by reference to particular corporate entities.



Creation of a new corporate employer and creation of a new purchaser for timber would augment and expand the trade or business of rendering services to corporations and selling timber to entities. Coverage of Sec. 166(d)(2)(A) requires only that the debt be created "in connection with a trade or business of the taxpayer". Petitioner's loans were an intricate part of RushMore's formation and development. After correctly recognizing that Petitioner was engaged in the business of rendering services to corporations as an officer and employee, and engaged in the business of selling timber to various entities for a profit, the Tax Court erred in failing to hold that loans essential to the formation of a new corporate employer and a new corporate purchaser of timber were loans created "in connection with" such trade or business.

Even if the scope of the trade or business in which Petitioner was engaged is limited to rendering services as an officer and employee to Lelco, Inc. and Lundgren Sales Corporation, and limited to the selling of timber to Lelco, Inc., such limitation does not preclude the establishment of a proximate relationship between such trade or business and the loans to RushMore. When a taxpayer is engaged in the business of rendering services to two corporations as an officer and employee for compensation, and engaged in the business of selling timber to one corporation at a profit, loans incident to the formation of a new employer and a new purchaser of timber are still loans made "in connection with" such trades or businesses.





*The Tax Court erred in expressing doubts as to whether Petitioner's advances of \$144,968.55 created a genuine indebtedness rather than equity contributions.*

#### ARGUMENT

The reasons stated by the Tax Court for doubting whether Petitioner's advances created a genuine indebtedness (R 49) indicate that the Tax Court is advancing a warmed over version of the thesis which this Court emphatically rejected in Taft v. Commissioner, 314 F. 2d 620 (9th Cir. 1963). There, the taxpayer, Taft, transferred business assets of \$106,931.82 to his majority owned corporation in exchange for an unsecured, noninterest bearing demand promissory note in the amount of \$106,931.82. Operating losses had previously exhausted paid-in capital, so the only assets of the corporation after the transaction consisted of the \$106,931.82 in assets received from Taft, offset by the \$106,931.82 note to Taft, giving the corporation a zero net worth. Emphasizing the zero net worth, the Tax Court held the consideration for Taft's note was placed at the risk of the business, and concluded therefrom that the note represented an equity rather than a creditor interest, John S. Taft, 20 CCH Tax Ct. Mem. 1135 (1961).

There was no equity cushion in Taft, and the \$106,931.82 consideration for Taft's promissory note was put at the risk of the business in that the corporation would be unable to pay



the note to the extent the amount realizable from the corporate assets was diminished by subsequent operating losses and decrease in asset value. Obviously, no outside source would have made an interest free advance of \$106,931.82 to Taft's corporation. If placing funds at the risk of the business, or inability to obtain funds from an outside source, are controlling factors in determining the debt vs. equity issue, this Court would have sustained the Tax Court in Taft rather than holding that the Tax Court's denial of debt recognition was clearly erroneous.

All of the Tax Court's doubts concerning the genuineness of Petitioner's advances relate to why no outside source would have made the loans, and highlight the comparative risk of Petitioner's advances over the secured position of the SBA. Petitioner's advances were placed at the risk of the business in that RushMore would be unable to pay the notes to the extent operating losses and decrease in asset value reduced the net amount realizable from the corporate assets below the \$125,000 equity capital. This risk is no different and no greater (if as great) than the risk assumed by Taft under his \$106,931.82 note.

Petitioner and Taft were willing to make advances upon terms which would repel an outside source because of motivations not possessed by an outside source. Taft had a collateral motivation by virtue of his continuing interest in the transferred assets through his majority common stock





ownership. As stated under the preceding specifications of error, Petitioner's motivation was not the 4% interest rate, but was the trade or business motivation of receiving compensation for services rendered and profit from the sale of timber to RushMore when elimination of the SBA restrictions permitted. A corporation would not be exploiting the potential of the situation if it accepted conventional loan terms from a person expecting to derive collateral economic benefits. The fact that collateral considerations motivate a person to advance funds upon more liberal terms and at greater risk than would an outside source merely confirms the potency of the collateral motivation. It does nothing by way of disproving an intent to create an indebtedness and attain the attributes of a creditor.

Intent has always been the touch stone of this Court's approach to the debt vs. equity issue. Taft v. Commissioner, supra, at 623, footnote 1, citing Wilshire & W Sandwiches, Inc. v. Commissioner, 175 F.2d 718 at 720 (9th Cir. 1949); Maloney v. Spencer, 172 F.2d 638 at 641 (9th Cir. 1949). When a transaction is highly documented and the instruments involved are conventional in form with no ambiguities, the best evidence of the intent of the parties is the manifestation thereof

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5 Taft also may have had trade or business motivations. Presumably, he received a compensation from the corporation for services rendered. The issue in Taft was whether payments upon the note should be taxed as a dividend, not whether the note was created in connection with Taft's trade or business.





contained in the instruments, at least where the supplementing  
documentation and the conduct of the parties do not disclose  
an intent contrary to that manifested by the instruments.

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6 In Kraft Foods Company v. Commissioner (2nd Cir. 1956) 232 F.2d 118 at 123, the Court states that the vast majority of debt v. equity cases involve "hybrid securities" - instruments which have some of the characteristics of the conventional debt and some of the characteristics of the conventional equity. When such hybrid securities are involved, a problem of characterization is one of considering each case on all of its facts, but when the instruments involved are conventional in form and contain no ambiguity on the face, the intent is determined by the objective manifestation thereof in the instruments. This portion of Kraft Foods Company is quoted with approval in the recent case of United States v. Snyder Bros. Co. (5th Cir. 1966) \_\_\_\_ F.2d \_\_\_\_; 66-2 USTC para 9573.

7 Wilbur Security Company v. Commissioner (9th Cir. 1960) 279 F.2d 657, and O. H. Kruse Grain & Milling v. Commissioner (9th Cir. 1960) 279 F.2d 123, are cases in this category where conduct conflicted with the documentation.

In Wilbur Security Company v. Commissioner, the promissory notes bearing a fixed rate of interest and definite maturity dates were executed representing obligations that had been in existence for a long number of years prior thereto upon which varying amounts had been paid by the corporation rather than a fixed rate. This Court rejected the taxpayer's contention that only the circumstances existing in the tax years involved should be examined. Rather, this Court held the facts for the subject years alone would not truly portray the actual relationship (279 F.2d at 662). In the instant case, the documentation commences with the formation of RushMore.

In O. H. Kruse Grain & Milling v. Commissioner, supra, no payments were made upon the promissory note until a Revenue Agent questioned the transaction a number of years after the due date. Bookkeeping entries inconsistent with debt recognition were explained as "mistakes", and the taxpayer did not appear as a witness. Although the Tax Court's opinion in Taft relied heavily upon Wilbur Security Company and O. H. Kruse Grain & Milling, this Court made only brief reference to Wilbur Securities Company.





to a first mortgage loan strongly indicate an intent on the part of the promisor and promisee to create an indebtedness. Petitioner's advances of \$144,968.55 were evidenced by promissory notes conventional in form subordinated only to the SBA first mortgage loan. Other documentation of the transaction, such as the SBA loan application (Ex 5-E) and SBA loan authorization (Ex 7-G) refer to Petitioner's advances as loans. A RushMore balance sheet prepared by an SBA representative shows Petitioner's advances as liabilities, not as capital stock (Ex 6-F). While mere labels do not control tax consequences,

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8 Subordination to a first mortgage creditor has never been raised as an obstacle to debt recognition. Even subordination to all general creditors, existing and future, (both as to principal and interest) is not fatal to debt qualification, as held in the leading case of Commissioner v. O. P. P. Holding Corp., 76 F.2d 11 (2nd Cir. 1935). Gilbert v. Commissioner, 248 F.2d 399 (2nd Cir. 1957) cites Commissioner v. O. P. P. Holding Corp., *supra*, as an example of permissible variation from classic debt. The recent case of United States v. Snyder Bros. Co., \_\_\_ F.2d \_\_\_ (5th Cir. 1966); 66-2 USTC, para 9573 recognizes that Commissioner v. O. P. P. Holding Corp., *supra*, represents the law on the effect of subordination but distinguished the fact situation on the grounds that the particular subordination provisions in Snyder Bros. Co. rendered the holder of the debentures "practically helpless" to enforce any rights as contrasted to the situation in O. P. P. Holding Corp., and Snyder Bros. Co. emphasized the lack of a restriction on payment of dividends during the period of subordination, such a restriction being present in O. P. P. Holding Corp. Here, Petitioner's notes were not subordinated to general creditors, the notes were fully enforceable upon demand after retirement of the SBA loan having a six year maturity, and the SBA loan agreement (Ex 12-L) prohibited RushMore from paying dividends or making any distributions upon or in redemption of its stock while the SBA loan was outstanding, a period co-extensive with the subordination of Petitioner's notes.





uniformity of terminology consistently applied in the documentation of a transaction certainly helps to ascertain the actual intent. This is particularly true when the terminology is employed by a reputable third party such as the SBA having no self serving motivation for the terminology.

Manifestation of Petitioner's creditor intent concerning the \$144,968.55 is not limited to the legal effect of the notes and the "loan" terminology. The forecast of cash receipts and disbursements attached as Exhibit 5 to the SBA loan application (Ex 5-E) projected repayment of Petitioner's advances in full by May, 1957 without reference to profits. When the SBA shortened the requested first mortgage term from ten to six years, and required subordination of Petitioner's advances, Petitioner altered his intent only to the extent required by the SBA condition. There is no indication that Petitioner made a complete about face and intended the \$144,968.55 as an indefinite commitment to equity capital. Petitioner's intent is reflected in an offering circular filed by RushMore with the Securities & Exchange Commission as part of a Regulation A registration (Ex 47-AU). After reciting Petitioner's common stock interest in RushMore, the offering circular contains the following statement at the bottom of page 6:

"In addition, Leonard Lundgren holds \$144,968.55 of notes of issuer, and Lelco, Inc., an Oregon corporation, holds a \$15,000.00 note of issuer, all to be paid after settlement of the Small Business Administration obligation under a standby agreement.

This confirms Petitioner's intent to have his advances paid as



on as possible after elimination of the SBA subordination without limitation to profits.

An additional note of realism is supplied when attainment of a creditor's attributes requires the giving up of equity benefits. This Court observed in Taft that the \$106,931.82 note resulted in no additional voting power for Taft and no change in his proportionate equity interest. Here, Petitioner's advances did not increase his voting power nor change his proportionate equity interest in RushMore. An increase in Petitioner's voting power would have given Petitioner and his wife the ability to vote more than two-thirds of the stock. A two-thirds vote is required under South Dakota law for mergers, consolidations and sale of assets, so an increase in Petitioner's voting power to two-thirds had meaning. Instead of taking this benefit which would have resulted from an additional stock interest, Petitioner sought the attributes of a creditor in regard to the \$144,968.55, the right to receive payment as soon as possible after retirement of the SBA loan, and the right to share with general creditors.

Duplicating the approach it took in Taft, 20 CCH Tax Ct. Mem. 1135 (1961), the Tax Court ignores all the individualized manifestations of intent, and applies the objective standards of whether an outside source would make the advances, and whether the advances were put at the risk of the business to a greater extent than the Tax Court deems proper under its version of prudent corporate financing. While such objective tests may have some evidentiary value in the absence of individualized manifestations, or in cases where the individ-





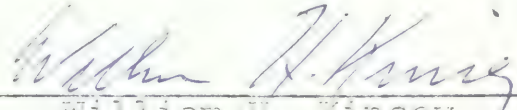
ualized manifestations give conflicting indications, the objective tests cannot override the preponderance of evidence that Petitioner's advances were intended to constitute and did constitute genuine indebtedness. Failure of the Tax Court to recognize Petitioner's advances as genuine indebtedness would be clearly erroneous if the question is one of fact, rather than a question of law or a mixed question of law and fact. Since the intent is documented in written instruments, the question seems to be one of law which this Court may decide, rather than remanding the case to the Tax Court for further proceedings on the debt vs. capital issue consistent with the law of this Circuit.

#### CONCLUSION

For the reasons set forth above, this Court should reverse the decision of the Tax Court and allow the \$129,000 business bad debt deduction claimed by Petitioners for 1961.

Respectfully submitted,

MAUTZ, SOUTHER, SPAULDING,  
KINSEY & WILLIAMSON

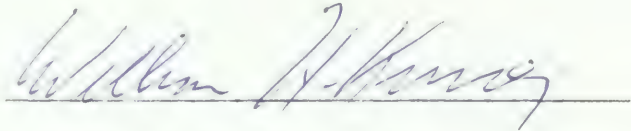
  
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I certify that, in connection with the preparation of this brief, I have examined Rules 18 and 19 of The United States Court of Appeals for the Ninth Circuit, and that, in my opinion, the foregoing brief is in full compliance with those rules.

A handwritten signature in dark ink, appearing to read "William E. Kinsey", is written over a horizontal line.

William E. Kinsey

Of Attorneys for Appellants



APPENDIX

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Exhibit No.	Offered	Identified	Received
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1-A through  
47-AU

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IN THE UNITED STATES COURT OF APPEALS  
FOR THE NINTH CIRCUIT

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LEONARD LUNDGREN and EVELYN R. LUNDGREN,

Petitioners

v.

COMMISSIONER OF INTERNAL REVENUE,

Respondent

---

ON PETITION FOR REVIEW OF THE DECISION OF THE  
TAX COURT OF THE UNITED STATES

---

BRIEF FOR THE RESPONDENT

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FILED

NOV 21 1966

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FEB 14 1967



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The Tax Court correctly determined that the amount of \$129,000, advanced by the taxpayer to his closely held corporation (RushMore) did not qualify for the bad debt deduction under section 166(a) of the Internal Revenue Code of 1954 because the advances were not created in connection with any trade or business the taxpayer was in, and were only partially worthless during the taxable year in issue----- 14

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## Miscellaneous:

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Treasury Regulations on Income Tax, Sec. 1.166-5 (26 C.F.R., Sec. 1.166-5)-----	14



FOR THE NINTH CIRCUIT

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No. 20,897

LEONARD LUNDGREN and EVELYN R. LUNDGREN,

Petitioners

v.

COMMISSIONER OF INTERNAL REVENUE,

Respondent

---

ON PETITION FOR REVIEW OF THE DECISION OF THE

TAX COURT OF THE UNITED STATES

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BRIEF FOR THE RESPONDENT

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OPINION BELOW

The memorandum findings of fact and opinion of the Tax Court

(I-R. 37-54) 1/ were not officially reported.

JURISDICTION

The petition for review (I-R. 56-58) involves federal income taxes for the taxable year 1961. On September 25, 1963, the Commissioner of Internal Revenue mailed to the taxpayers a notice of deficiency, asserting a deficiency in income tax in the amount of \$25,040.01. (I-R. 7.) Within ninety days thereafter, on December 22, 1963, the taxpayer filed a petition with the Tax Court for a redetermination of this deficiency under the provisions of Section 6213 of the Internal Revenue Code of 1954. (I-R. 1-11.) The decision of the Tax Court was entered on January 10, 1966. (I-R. 55.) The 1/ "I-R." and "II-R." references are to volumes I and II of the record on appeal.



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case is brought to this Court by a petition for review filed January 19, 1966 (I-R. 56), within the three-month period prescribed in Section 7483 of the Internal Revenue Code of 1954. Jurisdiction is conferred on this Court by Section 7482 of that Code.

QUESTION PRESENTED

Whether the Tax Court correctly found that the advances, totalling \$129,000, made by the taxpayer to his closely held corporation (RushMore) did not qualify for a deduction under Section 166(a) of the Internal Revenue Code of 1954 since the advances were not debts created or acquired in connection with a trade or business, and were only partially worthless during the taxable year in issue.

STATUTE INVOLVED

Internal Revenue Code of 1954:

SEC. 166. BAD DEBTS.

(a) General Rule.--

(1) Wholly worthless debts.--There shall be allowed as a deduction any debt which becomes worthless within the taxable year.

(2) Partially worthless debts.--When satisfied that a debt is recoverable only in part, the Secretary or his delegate may allow such debt, in an amount not in excess of the part charged off within the taxable year, as a deduction.

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(d) Nonbusiness debts.--

(1) General rule.--In the case of a taxpayer other than a corporation--

(A) subsections (a) and (c) shall not apply to any nonbusiness debt; and

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(B) where any nonbusiness debt becomes worthless within the taxable year, the loss resulting therefrom shall be considered a loss from the sale or exchange, during the taxable year, of a capital asset held for not more than 6 months.

(2) Nonbusiness debt defined.--For purposes of paragraph (1), the term "nonbusiness debt" means a debt other than--

(A) [as amended by Sec. 8, Technical Amendments Act of 1958, P.L. 85-866, 72 Stat. 1606] a debt created or acquired (as the case may be) in connection with a trade or business of the taxpayer; or

(B) a debt the loss from the worthlessness of which is incurred in the taxpayer's trade or business.

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(26 U.S.C. 1964 ed., Sec. 166.)

#### STATEMENT

The facts as found by the Tax Court not being subject to any material dispute, may be briefly stated as follows:

Leonard Lundgren, hereafter referred to as taxpayer, and Evelyn R. Lundgren are husband and wife residing in the State of Oregon. (I-R. 38.)

Taxpayer has been engaged in the timber and lumber manufacturing business during his adult life and conducted this business through individual proprietorships and partnerships. He has organized various timber and lumber businesses, has been, and now is an officer thereof, and now holds substantial stock holdings in corporations engaged in the timber and lumber manufacturing and sales business. (I-R. 38.)

Prior to October 1, 1951, taxpayer conducted a lumber manufacturing and sales business as a sole proprietorship in and around Bend, Oregon. Taxpayer purchased a portable sawmill, for use in this business in 1947 at a cost of \$31,366.65. (I-R. 46.)



On October 1, 1951, this business was taken over by the Leonard Lundgren Lumber Company, a partnership (hereafter referred to as the partnership"), the partners of which were taxpayer, Raymond B. Lundgren, and Orville A. Young. (I-R. 39,46.) The partnership took over the assets of the proprietorship at their adjusted basis; the adjusted basis of the portable sawmill was \$14,738.77.<sup>2/</sup> The initial net worth of the partnership, reflecting the adjusted bases of the assets at October 1, 1951, was \$210,628.04. Taxpayer had a seventy percent interest in the partnership, Raymond Lundgren had a twenty percent interest, and Orville Young had a ten percent interest therein. (I-R. 46.) The partnership was primarily engaged in the lumber and ranching business. (I-R. 39.)

Lundgren Sales Corporation, hereafter referred to as Sales, was formed in 1952 by taxpayer and his wife. All the stock of Sales has been and is held by them. Sales sold lumber produced by the partnership until 1956 and thereafter sold lumber produced by another corporation owned by taxpayer. (I-R. 46.)

In 1953, taxpayer organized a sole proprietorship to operate as a sawmill at Sisters, Oregon. This business, hereafter referred to as Sisters, sawed logs for the partnership until about March of 1956. The amount received by Sisters for work it performed was based upon a specified amount per thousand board feet of lumber manufactured, with an annual maximum. (I-R. 46-47.)

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<sup>2/</sup> This figure represents the difference between the cost of \$34,743.65, less depreciation of \$20,004.88. (I-R. 46.)

During the early part of 1956, the partners decided to reorganize the partnership. 3/ By an agreement dated February 15, 1956, the taxpayer, Raymond Lundgren, and Young caused the organization and incorporation of the RushMore Lumber Company, hereafter referred to as RushMore. RushMore was organized under the laws of South Dakota, for the purpose of setting up a sawmill operation in South Dakota. (I-R. 38-39.) On March 7, 1956, the partners formed Lelco, Inc., under the laws of Oregon. RushMore had an authorized capital of \$250,000 and paid-in capital of \$124,500. Lelco had an authorized capital of \$500,000 fully paid-in. (I-R. 22, 38-39; Ex. 5-E.)

Under the plan to reorganize the partnership, a major portion of its assets subject to all liabilities were transferred to Lelco. The balance of the assets were transferred to RushMore and the partnership was terminated. (I-R. 39.)

The February 15th agreement specified that the assets transferred to RushMore had a value of \$100,000 and that the partners would receive \$100,000 of capital stock, par value \$1, in proportion to their respective partnership interests. (I-R. 39.) The following table shows the assets transferred to RushMore and their respective values (I-R. 40):

<u>ASSETS</u>	<u>ADJUSTED BASIS TO PARTNERSHIP</u>	<u>ASSIGNED VALUE</u>
Portable sawmill consisting of sawmill and lumber rolls, portable welder, small motor, edger and saw type M-330 (edger motor No. 6001) and G.M. C. diesel	\$1,996.43	\$86,900.00

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3/ Sometime prior to 1956, taxpayer learned of certain timber in South Dakota which the Federal Government was going to sell. (I-R. 22; Ex. 5-E.)



<u>ASSETS</u>	<u>ADJUSTED BASIS TO PARTNERSHIP</u>	<u>ASSIGNED VALUE</u>
Lorraine Moto Crane	\$4,574.70	\$10,000.00
1936 Chevrolet express	12.87	100.00
1951 Hyster lift truck RT-150-23785	<u>1,600.00</u>	<u>3,000.00</u>
Totals	\$8,184.00	\$100,000.00

Immediately after accepting transfer of the assets in exchange for the \$100,000 of capital stock, RushMore received an additional \$25,000 in cash for the sale of 25,000 shares of its stock. Such stock was purchased as follows (I-R. 41):

	<u>Cost</u>	<u>Shares</u>
Evelyn R. Lundgren	\$4,500	4,500
Orville A. Young	1,000	1,000
Other individuals not re- lated to taxpayers	<u>19,500</u>	<u>19,500</u>
	\$25,000	25,000

Accordingly, capital stock, in RushMore was owned as follows (I-R. 41):

	<u>No. of Shares</u>	<u>Percentage of Ownership</u>
Leonard & Evelyn Lundgren	74,500	59.6
Raymond B. Lundgren	20,000	16.0
Orville A. Young	11,000	8.8
Other individuals not related to taxpayers <u>4/</u>	<u>19,500</u>	<u>15.6</u>
	125,000	100.00

4/ In 1959, RushMore acquired 9,000 shares of stock from certain of these individuals at the par value in exchange for the corporation's promissory notes. These notes were not paid and are still outstanding. Other than this, there has been no change in stock ownership since 1956. Such acquisition of the 9,000 shares increased the percentage interest of taxpayers to 65.35 percent. (I-R. 41.)



Pursuant to the authorization by its board of directors, RushMore applied to the United States National Bank of Portland, Oregon, for a loan of \$250,000. This loan application was rejected by the bank. (I-R. 41.)

Thereafter, RushMore applied to the Small Business Administration, hereafter referred to as SBA, for a loan of \$250,000. As a part of the application taxpayer, as president of RushMore, represented that no lending institution would participate with the SBA in making the loan. Taxpayer further represented that there were no present plans for compensation of the officers or directors of RushMore. (I-R. 41-42.) Appended to and forming a part of the application were various memoranda and financial statements. Among these was a letter dated July 20, 1956, from taxpayer and addressed to RushMore stating that he held two Government contracts for the purchase of timber in South Dakota covering approximately 28,000,000 feet of stumpage and stating that this stumpage would be made available to RushMore if and when needed. (I-R. 22-23; Ex. 6 attached to Ex. 5-E.)

On August 31, 1956, SBA approved the loan application and authorized a loan of \$250,000 with interest at six percent. (I-R. 42.) The loan authorization contained a number of conditions and numerous documents were required. (I-R. 25-27, 42.) Prior to the actual disbursing of those funds these conditions were met as follows (I-R. 25-27, 42-44):

1. Taxpayer personally guaranteed the \$250,000 loan.
2. Taxpayer gave a mortgage on his mill at Sisters, Oregon, to secure performance of his guaranty.

3. Taxpayer agreed to advance to RushMore, subsequent to June 30, 1956, not less than \$115,859 plus any amount by which the acquisition costs of the fixed assets for RushMore's sawmill facilities exceeded \$473,738. (This was in addition to \$29,000 taxpayer had already advanced to it).
4. Between June 30, 1956, and September 25, 1956, taxpayer advanced it cash in the amount of \$64,500. This was in addition to the \$29,000 taxpayer had already advanced prior to June 30, 1956.
5. Lelco supplied goods and services to RushMore which account or debt was purchased by taxpayer. This amounted to \$43,291.32. In addition Lelcos' travel advance to RushMore of \$808.44 was also acquired by taxpayer.
6. Sales advanced \$2,634.29 to RushMore which was also acquired by taxpayer.
7. Taxpayer caused a life insurance policy on his life to be assigned to SBA. Taxpayer paid a premium on this policy of \$4,734.50.
8. The advances by taxpayer were the subject of nineteen unsecured demand promissory notes with interest at four percent. Taxpayer, by standby agreement, agreed not to take any action to collect these notes, and further agreed that in case of bankruptcy, receivership, dissolution or liquidation



proceedings of RushMore, these notes would be considered as assigned to SBA. Taxpayer also agreed that the terms and conditions contained in the standby agreement would apply to all future loans made by taxpayer to RushMore.

9. Taxpayer sold, at his cost to RushMore, the two timber sales contracts in South Dakota.
10. Taxpayer, in his personal capacity, became a surety on a bond of \$200,000 to insure payment of all merchandise liens in connection with the construction of RushMore's facilities.
11. Taxpayer, as president of RushMore, agreed that no compensation was to be paid to the officers of RushMore without written approval of SBA.
12. Taxpayer, in his personal capacity, became surety on the performance bonds of timber purchased in the South Dakota area.

The conditions of the loan were met and RushMore received the \$250,000 loan proceeds in installments, the first in October of 1956, and the last in March of 1958. (I-R. 44.)

Sometime in early 1958, RushMore applied to SBA for a deferment of payment of the principal falling due from September 21, 1957, through July 21, 1958. As a condition to such deferment, SBA required taxpayer to execute an agreement dated February 14, 1958, under which he agreed to advance, or cause to be advanced, certain sums to RushMore covered by standby agreements. In compliance with the agreement, Lelco advanced

\$23,548.15 and Sales advanced \$23,705 covered by the standby agreement dated February 14, 1958. The board of directors of RushMore, on January 8, 1958, authorized RushMore to borrow from the United States National Bank of Portland, Oregon, a sum not to exceed \$25,000. (I-R. 44.)

During the operation of RushMore's mill, Sales sold lumber produced by RushMore. Sales also sold lumber produced by Lelco after its inception. Sisters sawed logs for Lelco also after its formation. (I-R. 46-47.)

On June 28, 1960, a fire at RushMore destroyed the sawmill and other related facilities but did not destroy the dry kilns and planing mill and certain other facilities. The book values of the destroyed assets at the time of the fire were as follows (I-R. 44-45):

Portable sawmill and related facilities transferred to RushMore by the partnership	\$86,900.00	<u>5/</u>
Equipment installed by RushMore	80,550.48	
Building constructed by RushMore	<u>9,540.69</u>	\$176,991.17
Less reserve for depreciation		<u>52,073.95</u> <u>6/</u>
		\$124,917.22

RushMore received insurance proceeds of \$124,307.24 for these destroyed assets. It was determined that the fire loss was \$147,529.04. Because RushMore's facilities were under insured, it received only the \$124,307.24 (\$125,000 less \$692.76 of scrap retained by it in lieu of cash). (I-R. 45.)

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5/ Amount assigned as actual value at time of transfer to RushMore, not book value of transferor partnership. (I-R. 45.)

6/ Includes depreciation of the \$86,900 on 10-year straight-line basis, not depreciation of the transferor's lower basis which RushMore was required to use for income tax purposes. (I-R. 45.)



SBA required that the insurance proceeds of \$124,307.24 be applied to reduce the indebtedness and, accordingly, this was done. (I-R. 45.)

On October 11, 1962, the \$250,000 note evidencing the loan was marked "paid" after certain other facilities of RushMore were sold to satisfy part of the loan to SBA. (I-R. 45.) Attempts were made to sell its remaining facilities as a unit, but were unsuccessful. (I-R. 45-46.)

Taxpayer performed services for various of his corporations. He received salaries from Sales and Lelco but he never received any salary from RushMore. Payment of this was prohibited by the SBA loan agreement. (I-R. 47.)

Taxpayer sold to the partnership, over a period of years, large quantities of timber. After the formation of Lelco, taxpayer continued to sell timber to the corporate successor of the partnership. (I-R. 47.) In selling timber, taxpayer did not advertise nor engage salesmen or realtors but merely supplied his operations with needed timber. (II-R. 96-97.) Taxpayer claimed capital gain treatment on such sales on the basis that timber and rights therein which he owned were capital assets. (I-R. 47.) 7/

Taxpayer did not sell any timber to RushMore at a profit. A condition in the loan authorization required that he sell to RushMore at his cost the timber covered by U.S.F.S. Contracts Nos. 12-11-002-11942, and 12-11-002-11943, respectively executed on March 7th and 8th of 1956. These were the only two sales of timber property by taxpayer to RushMore. With

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7/ For the tax years 1955 and 1956, in a protest to the District Director and in a petition to the Tax Court of the United States (Docket No. 78340), taxpayer claimed that timber and timber cutting contracts sold by him were capital assets. (Ex. 34-AH, Ex. 36-AJ pp. 3, 4.)



the exception of these Forest Service contracts, taxpayer did not own any timber or timber cutting rights in the South Dakota area. (I-R. 47-48.)

Taxpayer never sold stock in a corporation which he formed or caused to be formed or in a corporation controlled by him. He never received a dividend from any of his corporations. Taxpayer did not form RushMore as a promoter with the intention of selling the stock at a profit, collecting a promoter's fee or commission, or receiving any dividends. (I-R. 48.)

In his 1961 joint income tax return, taxpayer charged off as worthless, and took as a business bad debt deduction \$129,000 of the \$144,968.55 he advanced to RushMore. (I-R. 18, 48.) The Commissioner, in his statutory notice of deficiency (I-R. 7-10) disallowed the deduction in its entirety. The taxpayer filed a petition with the Tax Court for a redetermination of his deficiency. (I-R. 1-5.) The Tax Court, upon the record evidence, sustained the determination of the Commissioner. (R. 54.) Thereafter, taxpayer filed a petition for review to this Court. (I-R. 56.)

#### SUMMARY OF ARGUMENT

The Tax Court correctly determined that the amount of \$129,000, advanced by the taxpayer to his closely held corporation did not qualify for the bad debt deduction under Section 166(a) of the Code because the advances was not created in connection with any trade or business in which the taxpayer was engaged, and was only partially worthless during the taxable year in issue. Section 166(a) and (d) authorizes an ordinary loss deduction for business bad debts, and only a capital loss deduction for non-business bad debts.

A business bad debt may be deducted in whole or in part, depending upon the degree of its worthlessness, whereas a non-business bad debt can only be deducted in the year it becomes wholly worthless. A taxpayer qualifies for a business bad debt deduction only if he establishes that he was in a trade or business, and the debt bore a proximate relation to that trade or business of the taxpayer. A taxpayer is considered to be carrying on a trade or business only when the dominant intent behind his activity is to make a profit from the very activity. Moreover, that debt must bear a sufficiently direct relationship to the taxpayer's business to entitle him to a business bad debt deduction.

The Tax Court's decision that taxpayer had failed to establish that his advances were incurred in connection with a trade or business, not being clearly erroneous, is entitled to affirmance. The taxpayer failed to establish that he was in the business of being an employee of RushMore. Further, while the Tax Court found that taxpayer was in a trade or business with regard to his other enterprises, taxpayer failed to establish that any of his advances to RushMore bore a sufficiently direct relationship to these businesses to qualify the worthlessness therefrom as business bad debts.



ARGUMENT

THE TAX COURT CORRECTLY DETERMINED THAT THE AMOUNT OF \$129,000, ADVANCED BY THE TAXPAYER TO HIS CLOSELY HELD CORPORATION (RUSHMORE) DID NOT QUALIFY FOR THE BAD DEBT DEDUCTION UNDER SECTION 166(a) OF THE INTERNAL REVENUE CODE OF 1954 BECAUSE THE ADVANCES WERE NOT CREATED IN CONNECTION WITH ANY TRADE OR BUSINESS THE TAXPAYER WAS IN, AND WERE ONLY PARTIALLY WORTHLESS DURING THE TAXABLE YEAR IN ISSUE

A. Introduction

Section 166 of the Internal Revenue Code of 1954, supra, is the statutory authorization for the deduction of losses suffered by taxpayers as a result of bad or worthless debts. This section is exclusive and controlling here. Putnam v. Commissioner, 352 U.S. 82. Section 166 distinguishes between individuals and corporations. The latter may deduct from income all debts whether partially or wholly worthless. In the case of an individual, a distinction is made between non-business and business bad debts. A non-business debt is deductible only if it becomes entirely worthless in the taxable year, and the resulting loss is to be treated as a short term capital loss. A bad debt is a business bad debt and is deductible in whole or in part, to the extent of proven worthlessness if the debt is created or acquired in connection with, or incurred in the taxpayer's trade or business. Treasury Regulations on Income Tax (1954 Code), Section 1.166-5(b), provides:

Sec. 1.166-5 Nonbusiness debts.

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(b) Nonbusiness debt defined. For purposes of Section 166 and this section, a nonbusiness debt is any debt other than--

(1) A debt which is created, or acquired, in the course of a trade or business of the taxpayer, determined without regard to the relationship of the debt to a trade or business of the taxpayer at the time when the debt becomes worthless; or

(2) A debt the loss from the worthlessness of which is incurred in the taxpayer's trade or business.

The question whether a debt is a non-business debt is a question of fact in each particular case. The determination of whether the loss on a debt's becoming worthless has been incurred in a trade or business of the taxpayer shall, for this purpose, be made in substantially the same manner for determining whether a loss has been incurred in a trade or business for purposes of section 165(c)(1). For purposes of subparagraph (2) of this paragraph, the character of the debt is to be determined by the relation which the loss resulting from the debt's becoming worthless bears to the trade or business of the taxpayer. If that relation is a proximate one in the conduct of the trade or business in which the taxpayer is engaged at the time the debt becomes worthless, the debt comes within the exception provided by that subparagraph. The use to which the borrowed funds are put by the debtor is of no consequence in making a determination under this paragraph. For purposes of section 166 and this section, a nonbusiness debt does not include a debt described in section 165(g)(2)(C). See Sec. 1.165-5, relating to losses on worthless securities.

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(26 C.F.R., Sec. 1.166-5.)

Thus, for taxpayer to avail himself of the business bad debt provision of Section 166(a)(2), he must show that the loss suffered from the advances becoming worthless was proximately related to the conduct of a trade or business in which he was engaged at the time the



debt became worthless. 8/ Whipple v. Commissioner, 373 U.S. 193; United States v. Keeler, 308 F. 2d 424 (C.A. 9th); Weddle v. Commissioner, 325 F. 2d 849 (C.A. 2d).

Because the business of a corporation is distinct from that of its shareholders (Deputy v. duPont, 308 U.S. 489; Burnet v. Clark, 287 U.S. 410; Dalton v. Bowers, 287 U.S. 404), the individual shareholder who owns a group of corporate enterprises and manages his investments therein which may include occasional advances of money to them is not conducting a trade or business. His return is that of an investor's return and his bad debts are non-business even though the corporation is involved in a trade or business. Whipple v. Commissioner, supra; Higgins v. Commissioner, 312 U.S. 212; Kelly v. Patterson, 331 F. 2d 753 (C.A. 5th).

In Higgins the taxpayer had extensive investments in bonds and stocks as well as in real estate. He devoted a considerable portion of his time to the management of his investments and also maintained two offices where a total of five persons were employed for this purpose. Approximately one-third of this time and effort was devoted to the management of the investment in stocks and bonds. The Supreme Court, affirming the Board of Tax Appeals and the Court of Appeals, held that the management of the securities did not constitute a business of the taxpayer, so that the taxpayer could not deduct expenses incurred in connection with the management of the bonds and stocks.

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8/ Section 166 of the 1954 Code reenacted Section 23(k) of the 1939 Code with only one substantive change not relevant here. S. Rep. No. 1622, 83d Cong. 2d Sess., p. 124 (3U.S.C. Cong. & Adm. News (1954) 4621, 4654).



In Whipple the taxpayer had organized a number of corporations, contributing to each his own initiative and energy and such financial backing as it required. The Supreme Court, sustaining the Court of Appeals for the Fifth Circuit, held that the taxpayer's activities with regard to these corporations did not constitute a separate business, so that a bad debt resulting from a loan to one of these corporations did not constitute a business bad debt. It did not matter how many corporations were involved or how extensive taxpayer's activities had been, for the only return taxpayer could have derived from these activities was that of an investor. The Court stated (p. 202):

Devoting one's time and energies to the affairs of a corporation is not of itself, and without more, a trade or business of the persons so engaged. Though such activities may produce income, profit or gain in the form of dividends or enhancement in the value of an investment, this return is distinctive to the process of investing and is generated by the successful operation of the corporation's business as distinguished from the trade or business of the taxpayer himself. When the only return is that of an investor, the taxpayer has not satisfied his burden of demonstrating that he is engaged in a trade or business since investing is not a trade or business and the return to the taxpayer, though substantially the product of his services, legally arises not from his own trade or business but from that of the corporation.

Even when a taxpayer establishes that he is in a trade or business, he must further establish that the advances were proximately related to that business. Whipple v. Commissioner, supra; Weddle v. Commissioner, supra. In Whipple v. Commissioner, supra, the Supreme Court stated (p. 202):

Even if the taxpayer demonstrates an independent trade or business of his own, care must be taken to distinguish bad debt losses arising from his own business and those

actually arising from activities peculiar to an investor concerned with, and participating in, the conduct of the corporate business.

Further, the Court, in Whipple, supra, at p. 202, cautioned that the "non-business" bad debt provision--

was intended to accomplish far more than to deny full deductibility to the worthless debts of the family and friends. It was designed to make full deductibility of a bad debt turn upon its proximate connection with activities which the tax laws recognized as a trade or business, a concept which falls far short of reaching every income or profit making activity.

In the instant case, taxpayer had been engaged in the timber and lumber manufacturing businesses in Oregon. He had devoted a good deal of capital and time to these ventures. (I-R. 38.) Prior to 1951, he conducted this business as a sole proprietor at Bend, Oregon. After 1951, this business was reorganized into a partnership in which taxpayer had a seventy percent interest. The principal asset of this enterprise was a saw mill. (I-R. 46.)

During 1952, taxpayer organized and incorporated Sales for the purpose of acting as a sales agent for his lumber manufacturing businesses. All of the stock of Sales was owned by taxpayer and his wife. (I-R. 46.) At about this time taxpayer organized, as a sole proprietorship, the Sisters sawmill. (I-R. 46-47.)

During the operation of these businesses taxpayer bought and sold timber and timber cutting contracts to his enterprises. He generally claimed capital gain treatment for these sales on the basis that these assets were capital assets. (I-R. 47.)

The partnership was reorganized into two distinct corporations, Leico and RushMore. The majority of the assets were transferred to Leico which took over the Oregon operations. The balance of the assets



including a portable sawmill were transferred to RushMore. (I-R.39.) Taxpayer owned 59.6 percent of RushMore's stock after its incorporation and transfer of the partnership assets. (I-R. 41.)

Due to the fact that RushMore was unable to borrow money through banks, it had to seek assistance from SBA. (I-R. 41, 42.) As part of the conditions of such loan, taxpayer had to act as a guarantor, had to mortgage Sister's assets as collateral, and had to agree to forego collection of such advances under certain conditions. (I-R. 42-43.) In addition, taxpayer agreed to sell his timber interests in South Dakota to RushMore at cost. Further, taxpayer agreed that no salary would be paid to any officer of RushMore without SBA's approval. (I-R. 43.)

Thereafter, RushMore ran into financial difficulties and was unable to meet the SBA loan installments as they came due. Consequently, the taxpayer assumed certain appointed responsibilities under the standby agreements. Subsequently, a fire at RushMore destroyed the sawmill and related facilities. (I-R. 44.) RushMore received \$124,307.24 of insurance proceeds although the fire loss was about \$147,000. The insurance proceeds were required to be applied against the SBA loan. Thereafter, the note evidencing this loan was marked paid. (I-R. 45.)

Taxpayer's only timber interests in South Dakota were the two sales contracts he sold to RushMore at his cost. (I-R. 47-48.) Taxpayer did not own any timber or timber cutting rights in that area and he did not sell any other timber to RushMore. (I-R. 48.)

Upon consideration of the record evidence, the Tax Court sustained the determination of the Commissioner that the advances were only non-business bad debts and not deductible in the year claimed. The

Tax Court concluded that taxpayer was engaged in a trade or business of (1) rendering services to corporations as an officer and employee thereof, (2) of selling timber to various entities for profit, and (3) of operating a sawmill and manufacturing lumber at his plant in Sisters, Oregon. The Tax Court held that while taxpayer could be considered to be in the trade or business of being an employee in connection with services rendered to his various enterprises, he was not so engaged as far as his connection with RushMore was concerned. Further, it concluded that there was no proximate relation between his trade or business of being an employee of Lelco and Sales and his advances to RushMore. Additionally, the Tax Court concluded that there was no proximate relationship between his business of selling timber and his loans to RushMore. Finally, the lower court found that the record was devoid any evidence showing that his advances to RushMore bore a proximate relation to the operation in Sisters. (I-R. 48-54.) The conclusions of the Tax Court, being supported by the record evidence, are correct and should be affirmed on appeal.

The issues before the Court are basically factual and the Tax Court's holdings should not be overturned unless clearly erroneous. Higgins v. Commissioner, supra; Whipple v. Commissioner, supra; Hirsch v. Commissioner, 315 F. 2d 731 (C.A. 9th); United States v. Keeler, supra; Lamont v. Commissioner, 339 F. 2d 377 (C.A. 2d); Commissioner v. Duberstein, 363 U.S. 278. The taxpayer has the burden of proving that the facts bring his case within the elements necessary to entitle him to the deduction. Whipple v. Commissioner, supra; Hirsch v. Commissioner, supra; Lamont v. Commissioner, supra, p. 380 (C.A. 2d); United States v. Byck, 325 F. 2d 551 (C.A. 5th).



Taxpayer did not contend before the Tax Court and does not contend before this Court that he was in the business of either promoting corporations or loaning money and it is clear from the record evidence that he was not. (I-R. 35-36, 48.) See United States v. Byck, supra; Bodzy v. Commissioner, 321 F. 2d 331 (C.A. 5th.): United States v. Clark, 358 F. 2d 892 (C.A. 1st), rehearing denied 358 F. 2d 896, certiorari denied, October 10, 1966 (35 U.S. Law Week 3125). Taxpayer's contentions are (1) that he was in the business of being an employee of RushMore (2) that the loans bore a proximate relation to such employment, and (3) that in any event, the advances bore a proximate relation to the businesses which the Tax Court held he was in.



- B. The Tax Court correctly found that taxpayer was not in the business of being an employee of RushMore, and therefore it correctly concluded that the advances were not incurred in connection with any business of rendering services to RushMore

The spending of money, time and effort as a corporate executive or in any activity or venture in the general realm of business does not per se put taxpayer in the business of being an employee within the meaning of the statute. Hirsch v. Commissioner, supra, p. 36. This Court has clearly stated that the fundamental test in determining whether taxpayer is in a trade or business is whether the activities were engendered by a dominant income or profit motive. This Court stated with respect to this as follows (p. 736):

\* \* \* Congress intended that the profit or income motive must first be present in and dominate any taxpayer's "trade or business" before deductions may be taken. \* \* \* the basic and dominant intent behind the taxpayer's activities, out of which the claimed expenses or debts were incurred, must be ultimately to make a profit from those very same activities.

\* \* \* Absent that basic and dominant motive, the taxpayer's activities, no matter how intensive, extensive, or expensive, have not been construed by the Courts as carrying on a trade or business \* \* \*. (Emphasis supplied.)

Taxpayer cannot be contending that he is in the business in which RushMore was engaged since it is clear that the corporation and its stockholders and employees are to be treated separately and the business of the corporation is not the business of the employee. Whipple v. Commissioner, supra. Therefore, taxpayer's contention, although not clearly spelled out, is that his trade or business in relation to RushMore was that of an employee therein.

The evidence certainly does not establish that taxpayer's dominant purpose was that of making a profit as an employee of RushMore. Rather, it is clear that the services he performed for it were related to a dominant purpose of producing and insuring a return on his investment.

Preliminarily, taxpayer's extreme reliance (Br. 25) on the stipulation of fact (I-R. 35-36, 48) and findings of the Tax Court incorporating that stipulation (I-R. 38) to the effect that taxpayer did not form RushMore with the intention of selling the stock at a profit or receiving a dividend is not at all probative of the fact that he was in the business of being an employee of RushMore. One need not dig very deeply to discover ways to disguise a return on capital to an officer-shareholder as through the guise of a salary to that officer. See Botany Mills v. United States, 278 U.S. 282. Certainly one who has invested as much capital in RushMore as taxpayer has is going to seek a return on such capital aside from any normal remuneration for services rendered. Further, we are puzzled as to why taxpayer believes (Br. 19) the Tax Court's finding that taxpayer performed services for RushMore aids him in the least. Certainly, a majority shareholder in a closely held corporation will usually perform services for the corporation which only enhance or at least insure the value of his investment. What more productive activity can a prudent investor engage in than actively running the operation of the business he has invested in?

Taxpayer's activities with relation to RushMore were no more than that of an investor seeking a return on his investment. The Tax Court found (I-R. 42) that there were no present plans for compensation of the



officers or directors of RushMore and none were contemplated.

Contrary to what taxpayer states (Br. 19), the Tax Court did not find that taxpayer would have received a salary but for the SBA restrictions. The Tax Court more accurately found, in line with the stipulation of facts (I-R. 34), as follows (I-R. 47):

Petitioner never received a salary from RushMore, payment of any salary to him being prohibited by the S.B.A. loan agreement.

Perhaps taxpayer would have been compensated sometime in the future for his services by payment of a salary. However, taxpayer has not established when he would have been paid, how much, or how regular it was to be. Under these circumstances, his so-called salary is at the risk of the successful operation of the business which puts him in no better position than an investor waiting for a return on his capital. Taxpayer by his own testimony admits (II-R. 23) that it was his plan to start RushMore with as little capital as possible, do it on credit, skin by, and wait for the profit to come. Further, taxpayer stated (II-R. 34) that after SBA's restrictions were removed he hoped he could take a salary. This establishes that there was no definite expectation of salary at any time, but anticipation of some future profit on a capital investment. A salary is a regular and fixed compensation for continual services; taxpayer's remuneration was speculative and indefinite.

Taxpayer's whole argument on this point is that if there is some hope or expectation of taxpayer's being paid a salary in the future, then his undertaking suddenly becomes a trade or business of an employee.

Taxpayer relies (Br. 20) upon the statement from this Court's opinion in Hirsch (p. 736):

While the expectation of the taxpayer need not be reasonable, and immediate profit from the business is not necessary, nevertheless, the basic and dominant intent behind the taxpayer's activities, out of which the claimed expenses or debts were incurred, must be ultimately to make a profit or income from those very same activities.

Certainly this passage only emphasizes the burden on a taxpayer not merely to show some expectation of future profit but to show that the dominant intent is ultimately to make a profit on the activity of being an employee as opposed to that related to investment. This, the taxpayer has failed to do.9/

Trent v. Commissioner, 291 F. 2d 669 (C.A. 2d), relied by taxpayer (Br. 18), is basically distinguishable. While the court held, in that case, that a shareholder of a corporation can be in a trade or business of being an employee in that corporation, it did so on the basis of a factual situation far removed from that present in this case. In that case, taxpayer had been an employee of American Express Company for 16 years prior to accepting employment with Caldwell Inc. at a salary of \$150 a week. He also was to serve as vice-president and business manager of Plastic, Inc., of which Mr. Caldwell was half owner and

9/ See United States v. Clark, supra, p. 896 wherein the Court of Appeals, on petition for rehearing, stated (p. 896):

We thought Whipple to be controlling because of its clear implication that when a taxpayer's loss producing activities are at least equally consistent with his being an investor as with his being in the business of promoting, financing or managing the enterprises in question, he has not met his burden. (Emphasis supplied.)



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president. Taxpayer was required to pay \$5,000 for one third of the stock of Plastic. In addition Caldwell advised taxpayer he could be expected to make loans to Plastic & Caldwell, Inc., until their cash condition improved. In the instant case taxpayer owned seventy percent of RushMore, has continually been an entrepreneur in relation to all his business undertakings, and he was the moving force behind their successful operation. He was neither paid a salary nor were there any definite plans to pay him one in the future.

In relation to his services performed for RushMore, the taxpayer is in no different position than that of an investor. The Supreme Court's statements in Whipple, supra, clearly confirm this as follows (p. 197):

\* \* \* the case before us inexorably rests upon the claim that one who actively engages in serving his own corporations for the purposes of creating future income through those enterprises is in a trade or business. That argument is untenable in light of Burnet, Dalton, DuPont and Higgins, and we reject it. Absent substantial additional evidence, furnishing management and other services to corporations for a reward no different than that flowing to an investor in those corporations is not a trade or business under Sec. 23(k)(4).

C. The Tax Court correctly found that the taxpayer's advances were not proximately related to any of the business which the Tax Court found taxpayer to be engaged in

The Tax Court found that taxpayer was in the business of being an employee in connection with services rendered to Lelco and Sales, that he was in the business of operating a sawmill and manufacturing lumber at the Sisters plant, and that he was in the business of selling timber and timber rights. (R. 50, 52.) The Tax Court ultimately found that



that the taxpayer's advances bore no proximate relationship to these businesses sufficient to make the advances deductible as a business bad debts. (R. 51.) These findings of the Tax Court, not being clearly erroneous, are entitled to affirmance.

This Court in O'Neill v. Commissioner, 271 F. 2d 44, 48 (C.A. 9th), espoused a rule pertinent to the determination of whether a debt is incurred in a taxpayer's trade or business in the following (p. 48):

It is well settled that the only instances in which the taxpayer who owns a corporation, recognized as a tax entity, can take a business loss deduction for his financing of the corporation, either by way of loans or contributions to capital, are (1) where he is in the business of loaning money, or (2) he is in the business of promoting, financing, and managing business enterprise. Holtz v. Commissioner, 9 Cir., 1958, 256 F. 2d 865, 870; \* \* \*.

However, in United States v. Keeler, supra, this Court recognized additional factors which are pertinent to the determination, in the following (p. 429):

The government concedes that the O'Neill rule, while determinative in the circumstances presented in that case, is not the sole criterion, and that if the loans bear a sufficiently direct relationship to taxpayer's business, they may qualify as business debts, even though the taxpayer's business is not that of loaning money or promoting business enterprises. (Emphasis supplied.)

The Supreme Court's decision in Whipple, supra, which was rendered after this Court's decision in Keeler, did not, in any respect, modify the criteria espoused in Keeler, supra, since that Court reached no decision with respect to the issue of proximate relationship.<sup>10/</sup> The Supreme

<sup>10/</sup> While this Court has taken full cognizance of the Whipple decision in United States v. Drown, 328 F. 2d 314 (C.A. 9th), wherein it remanded a determination by the District Court that a taxpayer's activity in dealing in enterprises was a separate and distinct business in light of the Supreme Court's decision in Whipple, supra, it does not appear to have modified the rule espoused in Keeler, supra, p. 426.

- 20 -

Court specifically remanded the case for a further determination by the lower courts and stated that it took no position with regard to this issue. However, there is some general language in the Supreme Court's opinion pertaining to this issue. The Court stated as follows (pp. 201, 204):

[The 1942 amendment to Section 23(k) of the 1939 Code] \* \* \* was designed to make full deductibility of a bad debt turn upon its proximate connection with activities which the tax laws recognized as a trade or business, a concept which falls far short of reaching every income or profit making activity.

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\*

Moreover, there is no proof (which might be difficult to furnish where the taxpayer is the sole or dominant stockholder) that the loan was necessary to keep his job or was otherwise proximately related to maintaining his trade or business as an employee. (Emphasis supplied.)

While the Second Circuit in Trent v. Commissioner, supra, seems to have rejected the approach taken by this Court in O'Neill, supra, nevertheless that Circuit in Weddle v. Commissioner, supra, formulated a test which parallels this Court's test in Keeler, supra. The court in Weddle, supra, p. 851, stated that a bad debt which bears a proximate relation to a trade or business of a taxpayer is one in which the creation of that debt was significantly motivated by the taxpayer's trade or business. It seems significant to point out that Chief Judge Lumbard's concurring opinion in Weddle, supra, criticized the majority opinion and set out an even more restrictive test for measuring the proximate relationship of a debt to a trade or business. The Chief Judge stated (p. 852):



In attempting to draw this distinction, as the Tax Court wisely noted in considering Mrs. Weddle's claim, we have no "scales sufficiently sensitive to be able to ascertain the exact percentage of motivations which impelled [her actions]", and therefore "we look to the main and dominant reasons for [her actions]". (Emphasis supplied.)

Measured by the standard set down by this Court in Keeler, supra, or even by the Second Circuit in Weddle, supra, it is abundantly clear that taxpayer has failed to establish that his advances bore a proximate relationship to any trade or business he was adjudged to be engaged in. Viewing taxpayer's business of being an employee of Lelco and Sales, there is virtually little or no evidence which establishes that the advances were necessary for taxpayer to retain his employment in these corporations. Both Lelco and Sales maintained their independent economic existence aside from any business they received from RushMore and there was no showing that these entities were dependent upon RushMore's business or could not find sources elsewhere upon the demise of RushMore. With regard to taxpayer's business of buying and selling timber, the record demonstrates that while taxpayer owned and sold timber and timber cutting rights to his other businesses, he owned no timber or timber cutting rights in South Dakota. (R. 48.) Since he was required to sell his timber sales contracts at cost to RushMore, there was no apparent attempt to make a profit on any such sales. Therefore, the advances could not be deemed to have been made pursuant to any profit making activity or for the purpose of protecting any profit making activity. In any event, taxpayer has failed to establish that he could not have sold the timber sales contracts in South Dakota to buyers other than RushMore. Finally, the operation at Sisters, which sawed logs for Lelco, was totally

independent from RushMore and was not proven to have had any connection with RushMore, aside from common ownership and management.

Certainly the facts present in the instant case fall short of bringing it within the Trent doctrine or even the caveat in the Weddle case, supra, p. 851, quoted by taxpayer. (Br. 32.) In essence, taxpayer has failed to prove that the advances were necessary for him to maintain the trades or business he was in.11/

The facts present in Trent, supra, provide a significant contrast to those present in the instant case. The taxpayer in that case was only a minority shareholder and was required as a condition of his employment to make advances to the companies there involved. In the instant case, taxpayer was the dominant shareholder or owner in all his trades and businesses and the advances involved have not been shown to have been a necessary condition for the continuance of his businesses. Where the taxpayer is the dominant or sole shareholder in his trade or business, the burden of proving that the loan was necessary to preserve that trade or business is a difficult one, if not impossible. Whipple v. Commissioner, supra, p. 204. It is this burden which the taxpayer has fallen far short of satisfying.12/

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11/ In view of the fact that the Tax Court found that taxpayer was not in a trade or business with respect to his position of an officer in RushMore, the Tax Court made no findings with respect to the issue of whether his advances were proximately related to a non-existent business. However, if this Court should reverse the Tax Court's factual conclusion and hold that the taxpayer was in a trade or business of rendering services to RushMore, the Commissioner argues that it will be necessary to remand the cause back to the lower court for further findings on the issue of whether the advances were proximately related to this business.

12/ In the lower court, the Commissioner contended that the taxpayer's advances to RushMore, as are here in issue, constituted equity capital rather than debt. The Tax Court reached no conclusion with respect to this issue but did express "doubts" as to whether the advances created genuine indebtedness. (R. 49.) It stated (I-R. 49-50):

(contd on next page)



Because the advances were not created in connection with any trade or business that the taxpayer was in, and they were only partially worthless during 1961, the Tax Court correctly concluded that the amount of \$129,000 was not deductible at all.

#### CONCLUSION

For the reasons above, the decision of the Tax Court is correct and should be affirmed on appeal.

Respectfully submitted,

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NOVEMBER, 1966.

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12/ (contd from previous page)

The fact that no outside source would make the advances, the fact that the advances were subordinate to the S.B.A. loan, the fact that the advances had to be made before the S.B.A. would grant its loan, the fact that the interest rate was 4 percent while the S.B.A. interest rate was 6 percent, and the fact that the advances were all uninsured while the S.B.A. loan was fully guaranteed and covered by mortgages all seem to indicate that the advances were in reality contributions to the capital of RushMore.

The Commissioner contends that if this Court should reverse the Tax Court's decision, it should remand the cause to the Tax Court for further findings and conclusions on the issue of whether the advances were genuine indebtedness. Since this Court has held that the issue of whether advances by an individual to a corporation are debt or equity is basically one of fact (Los Angeles Shipbuilding & Drydock Corp. v. United States, 289 F. 2d 222 (C.A. 9th)), further findings are necessary.



CERTIFICATE

I certify that, in connection with the preparation of this brief, I have examined Rules 18, 19 and 39 of the United States Court of Appeals for the Ninth Circuit, and that, in my opinion, the foregoing brief is in full compliance with those rules.

Dated: \_\_\_\_\_ day of \_\_\_\_\_, 1966.

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Attorney

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IN THE UNITED STATES COURT OF APPEALS  
FOR THE NINTH CIRCUIT

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LEONARD LUNDGREN and EVELYN  
R. LUNDGREN,

Appellants,

v.

COMMISSIONER OF INTERNAL  
REVENUE,

Appellee.

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APPELLANTS' REPLY BRIEF

---

Appeal from the Tax Court of the United States

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Appeal from the Tax Court of the United States

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Respondent Fails to Recognize that  
Loans Incident to the Expansion of  
Existing Trades or Businesses into  
a New Geographic Area are Created  
"In Connection With" Such Trades  
or Businesses.

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Respondent accepts verbatim the Tax Court's key conclusion  
that Petitioner, Leonard Lundgren, was engaged in the trades or  
businesses of:

- (i) Rendering services to corporations as an officer and employee thereof, and
- (ii) Selling timber to various entities for profit.  
(Br. 20).

In addition, Respondent acknowledges that Petitioner was the moving force behind the operation of all his business undertakings.





An individual engaged in the trade or business of rendering services to corporations necessarily expands such trade or business when he forms a new corporate employer expected to generate additional compensation for services rendered. Likewise, an individual engaged in the trade or business of selling timber to entities at a profit necessarily expands such trade or business when he forms a new corporation in a new geographic area where timber is available and the new corporation is expected to purchase timber from the individual at a profit.

To escape the nonbusiness debt classification, loans only need be created "in connection with" a trade or business of the taxpayer. Loans essential to the creation of a new corporation which will expand existing trades or businesses certainly are created "in connection with" the existing trades or businesses. Nothing in Section 166(d)(2) requires that Petitioner's activities be fragmentized per corporate entity and per geographical area as done by the Tax Court and Respondent in order to avoid ascertaining a "connection" between:

(i) Petitioner's recognized trade or business of rendering service to Lelco, Inc. and Lundgren Sales Corporation, and Petitioner's recognized trade or business of selling timber to Lelco, Inc; and

(ii) The expansion of the before-mentioned trades or businesses into South Dakota through the formation of RushMore and the loans incident thereto.



There was nothing fanciful or illusionary about Petitioner's expectations of deriving economic benefits from the expansion of his individual trades or businesses into South Dakota through creation of a new corporate employer and a new purchaser of timber. Absent in the instant case is any competing motivation attributable to Petitioner's stock ownership in RushMore. As stipulated by the parties and found by the Tax Court, Petitioner did not form RushMore with the intention of selling the stock at a profit or receiving any dividends. This stipulation and finding confirms Petitioner's corroborated testimony that his formation of RushMore was motivated by the expectation of ultimately receiving (when permitted by elimination of the SBA loan restrictions) salary for services rendered to RushMore, and profit from the sale of timber to RushMore.

Although Respondent recognizes that Petitioner was engaged in the trade or business of rendering services to corporations because of his employment by Lelco, Inc. and Lundgren Sales Corporation, and in the trade or business of selling timber to the various entities because of Petitioner's timber sales to Lelco, Inc. and the predecessor partnership, Respondent denies that the advances were created in connection with such trades or businesses because:

"...In essence, taxpayer has failed to prove that the advances were necessary for him to maintain the trades or business he was in." (Br. 30)

Similarly, in the paragraph after the above quotation, Respondent expresses Petitioner's burden of proof as requiring a showing that the loan was necessary to *preserve* the trade or business.





On the preceding page, Respondent emphasizes the lack of evidence establishing that the advances were necessary for Petitioner to retain his employment with Lelco, Inc. or Lundgren Sales Corporation (Br. 29). It is perfectly true, as Respondent claims, that Petitioner could have continued his corporate employment business with Lelco, Inc. and Lundgren Sales Corporation, and his timber sales business with Lelco, Inc. in the absence of loans to Rush-More. Venturing into South Dakota was not required for continuation of Petitioner's individual trades or businesses in Oregon. While loans necessary to maintain an existing trade or business in its present form at the same location serving the same customers are certainly created "in connection with" such trade or business of the taxpayer, maintaining the status quo is not the *exclusive* manner in which a loan may be created "in connection with" a trade or business. The term "in connection with" is broad in scope. Loans incident to the expansion of an existing trade or business into a new geographic area have as direct a connection with the trade or business sought to be expanded as loans required for the survival or continuation of the trade or business.

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Contrary to the assertions made by Respondent (Br. 25), Petitioner does not rely upon Trent v. Commissioner, 291 F.2d 669 (C.A. 2d Cir. 1961) for purposes of sustaining the proximate relationship. Petitioner cited Trent v. Commissioner only in footnote 2 on page 18 of the opening brief for the general proposition that the performance of services as an employee constitutes the conduct of a trade or business. The difference in the fact situation between Trent and the instant case is recognized. The loans were made by the taxpayer in Trent to preserve his job while the loans were made by the Petitioner to Rush-More for the purpose of expanding his trade or business of performing services for corporations through the creation of a new employer.



Respondent's restricted interpretation of the term "in connection with" may stem from his reliance on the statement of this Court in United States v. Keeler, 308 F.2d 424 (9th Cir. 1962) that loans must "bear a sufficiently direct relationship to taxpayer's business" before they qualify as business debts (Br. 27). As reviewed under the next heading, when United States v. Keeler is analyzed, it supports Petitioner, not Respondent.

Respondent Misinterprets the  
Import of This Court's Opinion  
in United States v. Keeler

United States v. Keeler involved a taxpayer who conducted an industrial laundry business through a partnership owned and controlled 82.5% by him. Joining with two other individuals likewise engaged in the industrial laundry business, the taxpayer formed a Canadian corporation to conduct the same type of industrial laundry business in Toronto, Ontario. Financial adversity beset the Canadian corporation, and the taxpayer claimed a business bad debt deduction for \$88,588.90 in unpaid advances made by him to the corporation.

The industrial laundry business in Seattle was the only trade or business cited by the taxpayer in Keeler for purposes of satisfying the "in connection with" requirement of the non-business debt exclusion. Conduct of the industrial laundry business in Toronto by the Canadian corporation could not be considered an expansion of the taxpayer's Seattle laundry business because the business of a corporation is separate and distinct from that of a stockholder. In an effort to establish





a proximate relationship between the Seattle laundry business and the laundry business conducted by the Canadian corporation in Toronto, the taxpayer cited a number of indirect ways whereby the Toronto operation was expected to benefit the Seattle laundry business. After observing that these anticipated indirect benefits to the Seattle business seemed more fanciful than real, this Court held they did not establish a sufficiently close relationship to warrant the deduction of the advances as a bad debt even if the claimed benefits were accepted at face value.

If, in the instant case, Petitioner pointed to the lumber manufacturing business in Oregon for purposes of satisfying the "in connection with" requirement of the nonbusiness debt exclusion, the lumber manufacturing business conducted by RushMore in South Dakota could not be considered as an expansion of Petitioner's individual business because the business of a corporation is separate and apart from that of the stockholder. However, Petitioner, unlike the taxpayer in Keeler, relies upon the business of rendering services to corporations and the business of selling timber to entities for purposes of establishing the requisite connection with RushMore's business. While the lumber manufacturing business of RushMore could not be considered as an expansion of Petitioner's individual lumber manufacturing activities in Oregon, the business of RushMore could expand the corporate employment business of Petitioner by furnishing another employer, and expand Petitioner's timber sales business by supplying a new purchaser in a new geographic area. In short, the fact situation faced by this Court in Keeler was much different from the situation here presented.



The complexion of United States v. Keeler is completely changed when the facts are reconstructed to parallel those here involved. Such reconstructed facts are:

(1) The Seattle industrial laundry business was conducted through a corporation, successor to a partnership.

(2) The taxpayer individually was engaged in the business of selling soap to the Seattle industrial laundry corporation, and the taxpayer had similarly been engaged in the business of selling soap to the predecessor partnership.

(3) Sales for the Seattle laundry were handled by a separate sales corporation.

(4) The taxpayer was president of, performed services for, and received compensation from the Seattle laundry corporation and the sales corporation.

(5) Respondent recognized: that the taxpayer was engaged in the trade or business of rendering services to corporations as an officer and employee; and Respondent recognized that the taxpayer was engaged in the trade or business of selling soap to various entities.

(6) Respondent had stipulated that the taxpayer did not participate in the formation of the Canadian corporation with the intention of selling the stock at a profit or receiving any dividends.

(7) The economic benefits which the taxpayer hoped to derive from the Canadian corporation were: compensation for services rendered as president, and profit from the sale of soap, such compensation for services and profit from soap sales to commence after elimination of first mortgage loan restrictions incurred in connection with plant financing.

Under such facts, as reconstructed, loans to the Canadian corporation would have been created in connection with the taxpayer's trade or business of rendering services to corporations, and in connection with the taxpayer's trade or business of selling soap to entities, because the sole purpose and motivation behind





the taxpayer's participation in the formation of the Canadian corporation (and the loans incident thereto) would have been the expansion of his trades or businesses. Under such a fact situation, it would make no difference that no actual soap sales had been made to the Canadian corporation at a profit at least where the taxpayer had sold two truckloads of soap to the corporation at cost as required by the first mortgage restrictions, and the taxpayer knew he could obtain a Canadian supply of soap for sale to the Canadian corporation by the time elimination of the first mortgage loan restrictions permitted realization of profit from such sales.

In Keeler, the indirect benefits which the taxpayer's Seattle laundry business hoped to derive from the Canadian operation were admittedly anticipated future benefits, none of which actually materialized, and most of which required the establishment of a chain of industrial laundries in Canada, not merely successful operation of the Toronto laundry. If failure of a taxpayer to actually realize the motivating economic benefits precludes the relationship from being sufficiently direct to satisfy the "in connection with" requirement of the nonbusiness debt exclusion, this Court would have so stated in an abbreviated opinion. Instead, Keeler treats reasonably anticipated future benefits (as contrasted with fanciful benefits) in the same category as benefits actually received. If the benefits which Petitioner expected to receive from RushMore (compensation for services rendered and profit from the sale of timber) are considered as actually realized,



all grounds for the Tax Court's and Respondent's denial of the bad debt deduction are eliminated since their denial is founded upon the fact that Petitioner never received any compensation from RushMore, and never sold any timber to RushMore at a profit.

A pertinent question to be answered in all business vs. nonbusiness bad debt cases is: what really motivated the taxpayer to make the loans? This key question was answered as follows in United States v. Keeler, supra at 430:

"The taxpayer here testified that in addition to the alleged benefits to his Seattle plant, he expected to realize profits from the Toronto plant and the other contemplated Canadian laundries."

The profits referred to in the above quotation were profits attributable to the taxpayer's stock ownership in the Canadian corporation. What if this Court had been convinced that Petitioner was really motivated by the alleged benefits to his Seattle plant, rather than by anticipated profits attributable to his stock ownership? In such event, this Court might well have found the requisite relationship despite the indirect nature of the alleged benefits. In the instant case, it is stipulated that Petitioner did not form RushMore with the intention of selling the stock at a profit or receiving any dividends, thereby eliminating profit attributable to stock ownership as a motivating factor. This substantiates Petitioner's testimony that he was really motivated by the expectation of receiving compensation from RushMore for services rendered, and profits from the sale of timber to RushMore. Such motivating benefits are direct benefits to be derived from his trade or business of





performing services for corporations and his trade or business of selling timber to entities, not indirect benefits such as those asserted by the taxpayer in Keeler.

Respondent further cites United States v. Keeler as authority for his assertion that the issues before the Court are basically factual and the Tax Court's holdings should not be overturned unless clearly erroneous. Keeler actually holds to the contrary. The District Court had allowed Keeler the bad debt deduction by finding that the taxpayer entered into the transactions with the Canadian corporation for the benefit of, and to aid and nurture and build up his going business in Seattle. This Court reversed without any "clearly erroneous" assertions, stating that the question for determination was whether the factual situation found by the trial court was covered by the statute, a matter which may be reviewed by the appellate court. Id. at 432. The identical situation is here presented. Petitioner does not contest any of the evidentiary facts found by the Tax Court. Rather, Petitioner claims the factual situation found by the Tax Court falls within the non-business bad debt exclusion under Section 166(d)(2)(A).



Qualification Under the Nonbusiness  
Debt Exclusion is Clinched by the  
Fact that Petitioner's Activities  
Connected with RushMore Constituted  
the Conduct of Trades or Businesses

All of the foregoing argument applies whether or not Petitioner's activities connected with RushMore in and of themselves constitute the conduct of trades or businesses apart from his services performed as officer of Lelco, Inc. and RushMore Sales Corporation and apart from his sales of timber to Lelco, Inc. If, however, Petitioner's activities connected with RushMore constitute the conduct of the trade or business of performing services for RushMore or the trade or business of selling timber to RushMore, there is an undeniable connection between Petitioner's loans vital to the formation of RushMore and the conduct of such trades or businesses. It is not then a matter of expanding existing trades or businesses as is the case when Petitioner's employment by Lelco, Inc. and Lundgren Sales Corporation and Petitioner's timber sales to Lelco, Inc. are cited as the trades or businesses in connection with which the loans were created.

Respondent and Petitioner not only agree that Whipple v. Commissioner, 373 US 193 (1963) is the leading case concerning the circumstances under which devotion of time and energies to the affairs of a corporation by a controlling stockholder may be considered the conduct of a trade or business, but Respondent and Petitioner agree upon the precise portion of the





Supreme Court's opinion which is most pertinent to the issue.

The import of the Whipple doctrine is summarized as follows by Respondent (Br. 17):

"...It did not matter how many corporations were involved or how extensive taxpayer's activities had been, for the only return taxpayer could have derived from these activities was that of an investor."

In the above quotation, Respondent recognizes that extensive activities by a controlling stockholder fail to constitute the conduct of a trade or business where an investor's return is the only economic benefit which the stockholder hopes to derive from the activities.

A completely different situation is presented when an investor's return is negated as the economic motivation and when the monetary benefits sought from the corporation by the active

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This portion of the Supreme Court's opinion in Whipple is cited on page 17 of Respondent's brief, is likewise quoted in footnote 4 on page 22 of Petitioner's brief. For convenience of reference, the quotation is repeated below. (373 U.S. 193 at 202):

"Devoting one's time and energies to the affairs of a corporation is not of itself, and *without more* a trade or business of the person so engaged. Though such activities may produce income, profit or gain in the form of dividends or enhancement in the value of an investment, this return is distinctive to the process of investing and is generated by the successful operation of the corporation's business as distinguished from the trade or business of the taxpayer himself. *When the only return is that of an investor*, the taxpayer has not satisfied his burden of demonstrating that he is engaged in a trade or business since investing is not a trade or business and the return to the taxpayer, though substantially the product of his services, legally arises not from his own trade or business but from that of the corporation."  
(emphasis added)



controlling stockholder can only be obtained through the conduct of trades or businesses. The following quotations from Respondent's brief indicate his awareness of the necessity for establishing that an investor's return was the dominant motivation for Petitioner's activities connected with RushMore:

"...Rather, it is clear that the services he performed for it [RushMore] were related to a dominant purpose of producing and insuring a return on his investment." (Br. 23)

.....

"Taxpayer's activities with relation to RushMore were no more than that of an investor seeking a return on his investment." (Br. 23)

These assertions conflict with the stipulation that Petitioner did not form RushMore with the intention of selling the stock at a profit or receiving any dividends. The portion of Whipple quoted in the footnote at the bottom of page 12 above defines what is meant by an investor's return. It is income, profit or gain in the form of dividends or enhancement in the value of an investment. Profit or gain from enhancement in the value of a corporate investment can only be realized through sale of the corporate stock for more than the cost thereof. Such expectation did not motivate Petitioner, because, as stipulated Petitioner did not form RushMore with the intention of selling the stock at a profit or receiving any dividends.

In an effort to circumvent the stipulation, Respondent observes that a return on capital may be extracted from a corporation through the guise of a salary, and infers that this was Petitioner's intention because "...One who has invested as much capital in RushMore as taxpayer has is going to seek a return





on such capital aside from any normal remuneration for services rendered." (Br. 23). It may be true, as Respondent suggests, that one who has advanced as much as Petitioner advanced to RushMore will seek an economic benefit from the corporation over and above normal remuneration for services rendered. This does not, however, dictate the conclusion that the additional economic benefit must be the return of an investor, particularly when such a conclusion conflicts with the stipulation. Rather, the added economic motivation (over normal remuneration for services rendered) expected by Petitioner was gain from the sale of timber to be realized after elimination of the SBA loan restrictions. Nowhere does Respondent's brief discuss, or even mention, the economic motivation attributable to Petitioner's expectation of realizing gain from the sale of timber to RushMore.

Only one other assertion is made by Respondent in support of his contention that Petitioner's activities relating to RushMore were no more than those of an investor seeking a return on his investment. Respondent claims receipt of a salary from RushMore was at the risk of the successful operation of the business since no salary could be received until the SBA restrictions were eliminated. Therefore, according to Respondent, Petitioner is in no better position than an investor waiting for a return on his capital which is likewise at the risk of the successful operation of the business. Dependency of the ultimate realization of the profit or income upon the successful operation of a business does not preclude activities of a taxpayer from



constituting the conduct of a trade or business. This is the clear import of Hirsch v. Commissioner, 315 F.2d 731 (9th Cir. 1963) as evidenced in the following extract from this Court's opinion (Id. at 737):

"Even conceding that the taxpayer has proved he actively participated in the management of the Jockey Club, nevertheless his activities must still be subjected to the fundamental test: viz., were those activities engendered by a dominant income or profit motive?

.....

"...Even though Hirsch specially requested a finding that he had performed his duties as a member of the executive committee with full expectation of receiving compensation at such time as the track was successful, the Tax Court made no such finding."

The strongest finding sought by Hirsch was that he expected compensation at such time as the track was successful. It seems clear that the decision of this Court would have been different in Hirsch if the Tax Court had made the requested finding and a stipulation had negated the return of an investor as an economic motivation.

Where there are two economic motivations for extensive activities of a taxpayer connected with a corporation, it should be immaterial which of the two motivations dominated when realization of both require the conduct of a trade or business for realization. It would be different if one motivation involved the conduct of a trade or business but the other did not (such as being the anticipated return of an investor). Consequently, it should make no difference whether Petitioner's dominant intent was to receive compensation for services rendered after elimination of the SBA restrictions, or whether





his dominant intent was to realize profit upon the sale of timber to RushMore when permitted by elimination of the SBA restrictions

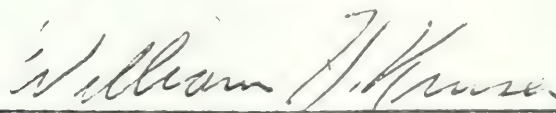
Nobody devotes extensive time and efforts to the affairs of a corporation unless he is motivated by the expectation of monetary remuneration. With the return of an investor eliminated by stipulation as a motivating economic benefit, Petitioner obviously expected to receive compensation for services rendered and gain from the sale of timber to RushMore as soon as permitted by elimination of the SBA loan restrictions. Both of these motivating economic benefits involved and required the conduct of a trade or business. This should be sufficient to comply with the nonbusiness debt exclusion of Section 166 (d) (2) (A) which merely requires that the loans be created "in connection with" a trade or business of the taxpayer.

#### CONCLUSION

For the reasons stated herein and in the opening brief for the Petitioners, the decisions of the Tax Court should be reverse

Respectfully submitted,

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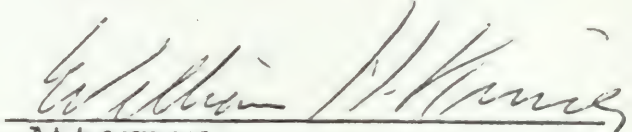
Attorneys for Petitioners



CERTIFICATE

I certify that in connection with the preparation of this brief, I have examined Rules 18 and 19 of the United States Court of Appeals for the Ninth Circuit, and that, in my opinion, the foregoing brief is in full compliance with those rules.

Dated: December 9, 1966.

  
Attorney





CERTIFICATION OF SERVICE

I, WILLIAM H. KINSEY, attorney for appellants, hereby certify that I served three copies of this reply brief on the United States Department of Justice, attorney for the Commissioner of Internal Revenue on the 9th day of December, 1966, by mailing to it three true and correct copies thereof, certified by me as such. I further certify that the three said copies were placed in a sealed envelope addressed to the United States Department of Justice at Washington, D.C.; said sealed envelope was then deposited in the United States Post Office at Portland, Oregon on the day last mentioned with the postage thereon fully paid.

  
\_\_\_\_\_  
William H. Kinsey

of Attorneys for Appellants



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**United States Court of Appeals**

FOR THE NINTH CIRCUIT

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DRAGOR SHIPPING CORPORATION, a corporation formerly  
Ward Industries Corporation,

*Appellant,*

vs.

UNION TANK CAR COMPANY, a corporation,

*Appellee.*

---

ON APPEAL FROM THE DISTRICT COURT OF THE UNITED STATES  
FOR THE DISTRICT OF ARIZONA

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**OPENING BRIEF OF APPELLANT,  
DRAGOR SHIPPING CORPORATION**

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# United States Court of Appeals

FOR THE NINTH CIRCUIT

---

DRAGOR SHIPPING CORPORATION, a corporation formerly  
Ward Industries Corporation,

*Appellant,*

vs.

UNION TANK CAR COMPANY, a corporation,

*Appellee.*

---

ON APPEAL FROM THE DISTRICT COURT OF THE UNITED STATES  
FOR THE DISTRICT OF ARIZONA

---

## OPENING BRIEF OF APPELLANT, DRAGOR SHIPPING CORPORATION

The defendant-appellant, Dragor Shipping Corporation, formerly known as Ward Industries Corporation, (and hereinafter designated as "Dragor") appeals from a judgment entered against it on December 7, 1965 by the United States District Court for the District of Arizona, Tucson Division, in favor of the plaintiff-respondent, Union Tank Car Company, (hereinafter designated as "Union"), dismissing for want of prosecution the compulsory counterclaim contained in the answer which Ward had been compelled to file in the within action. Under Rule 41(b) of the Federal Rules of Civil Procedure, the judgment of dismissal is a judgment on the merits.



## **Jurisdictional Statement**

Jurisdiction of the appeal exists under and by virtue of Sections 1291 and 2107, Judicial Code, Title 28, U. S. C. The jurisdiction of the District Court over the person of Dragor was continuously challenged and contested in the Court below.

On April 7, 1966, this Court unanimously held, upon the first appeal herein, (No. 20416), that the Arizona District Court never acquired any jurisdiction over the person of Dragor in this case. Its comprehensive opinion is reported in 361 Fed. (2d) 43.<sup>1</sup>

## **Statement of the Case**

The within action was purportedly commenced on December 23, 1964 by the plaintiff, a New Jersey corporation, with its principal office in the State of Illinois, against the defendant, a Delaware corporation, with its principal office in the State of New York. Service of process upon Dragor was sought to be effected by service upon the Arizona Corporation Commission and the C. T. Corporation, Dragor's former statutory agent in the State of Arizona, ostensibly under the terms and provisions of Sec. 10-481 (a) (2) of the Arizona Corporation Statutes (R. 1, pp. 12-14). No process was ever served personally upon Dragor within the territorial confines of the State of Arizona.

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<sup>1</sup> The Record on Appeal herein includes the Record upon the prior appeal, No. 20416, which will be designated in the page references of this brief as R. 1, as well as additional documents and matter which will be designated in page references as R. 2. (Appellant's Designation of Record on Appeal, R. 2, pp. 222-224, and Clerk's Certificate to Record on Appeal, R. 2, pp. 234-235).

Dragor appeared specially to quash, vacate and annul the service of process and contest the jurisdiction of the Arizona District Court over its person (R. 1, pp. 15-16). Its motion to quash the service of process and dismiss the complaint was denied by the Arizona District Court on February 2, 1965, without opinion (R. 1, p. 182). Subsequently, after all of its efforts to procure an interlocutory review of that decision had failed, efforts which were bitterly resisted by the plaintiff herein, Dragor was forced to file its answer which set forth, among other things, a compulsory counterclaim based upon Union's breach of the New York settlement agreement and covenant not to sue executed by and between the parties hereto. The denial of Dragor's efforts, more fully described below, to procure an interlocutory review of the District Court's refusal to quash the service of process was predicated upon the argument advanced by Union that the filing of an answer and compulsory counterclaim could not possibly constitute a waiver of Dragor's *in personam* jurisdictional objections or confer any *in personam* jurisdiction upon the District Court which it otherwise would not possess.

In its answer and compulsory counterclaim, Dragor reasserted, among other things, its constitutional objections to the jurisdiction of the District Court and its disavowal of any intent to waive those objections. Thereafter, Union moved for a judgment on the complaint and, also, for a dismissal of the compulsory counterclaim as insufficient in law (R. 1, pp. 117; 110). Although the Arizona District Court denied the plaintiff's motion to strike the compulsory counterclaim as insufficient in law, it granted the plaintiff's motion for judgment on the complaint (R. 1, p. 184). A judgment in favor of Union against Dragor for the sum of \$1,037,500. was entered by the District Court on June 1, 1965 (R. 1, p. 151).

Subsequent to the entry of the aforementioned judgment, Dragor moved for leave to discontinue its compulsory counterclaim without prejudice, urging as one of the grounds therefor that the *in personam* jurisdiction of the District Court was the subject of a pending appeal to this Court, and that, were Dragor successful, "all of the proceedings in this Court will be nullified *ab initio*" (R. 2, p. 149). Dragor's reassertion of its constitutional objections to the jurisdiction of the District Court was characterized by Union as "unseemly" (R. 2, p. 177). Upon the argument of Dragor's motion which the District Court denied (R. 2, p. 232), it announced that, regardless of this Court's disposition of the pending appeal, it intended to proceed with a trial of the compulsory counterclaim. (Dragor's Reply Brief, appeal #20416, pp. 18-19). Dragor thereupon refused to participate in the trial scheduled by the Court for December 7, 1965 (R. 2, pp. 204-206).

Before Dragor's appeal from the judgment of \$1,037,500. could be heard by this Court, the District Court entered a second judgment on December 7, 1965 dismissing Dragor's compulsory counterclaim for lack of prosecution (R. 2, p. 207). The present appeal is the appeal taken by Dragor from the District Court's second judgment of December 7, 1965 dismissing Dragor's compulsory counterclaim for want of prosecution (R. 2, p. 208). Under Rule 41(b) of the Federal Rules of Civil Procedure, such a dismissal is a dismissal upon the merits.

Dragor's appeal from the judgment of \$1,037,500. was heard by this Court in March of 1966. On April 7, 1966, this Court reversed that judgment as a nullity, quashed and vacated the service of process in this action, and dismissed Union's complaint upon the ground that the Arizona District Court never acquired jurisdiction over the person of Dragor in this action.



In its learned and dispositive opinion, 361 Fed. (2d) 43, this Court ruled that the causes of action set forth in Union's complaint "pertain only to the settlement agreement and note executed and delivered in New York" (p. 49); that Union's suit was "exclusively predicated upon claims arising in New York" (p. 49); and that New York was the place "where this cause of action arose" (p. 49). It thereupon concluded (p. 49):

"The result which we reach here places no hardship upon Union, but protects Dragor from the hardship of being hauled across the country to defend itself in a suit exclusively predicated upon claims arising in New York. Union is a New Jersey corporation and has its principal place of business in Illinois. Nothing in this record suggests how it will be prejudiced by suing Dragor in Delaware, where it was incorporated, or New York, where it has its principal place of business and where this cause of action arose. Arizona has no interest in providing Union with a forum for such an action."

In sustaining Dragor's contention upon the prior appeal "that the Arizona District Court's assumption of jurisdiction over the person of Dragor and thereby over the subject matter of this action deprived Dragor of due process, and is, therefore, unconstitutional" (p. 45), this Court's decision of April 7, 1966 irrefutably established the District Court's constitutional inability to enter a valid judgment in this case. That decision is binding and conclusive upon the parties hereto, and automatically vitiates the second judgment of the District Court which is the subject of the within appeal.

Notwithstanding the fact that the judgment of the District Court dismissing Dragor's compulsory counterclaim



in this cause on December 7, 1965 is a nullity, it cannot be ignored by Dragor. Under existing law, a judgment entered by a District Court after it has improperly overruled an objection to the *in personam* jurisdiction of the Court can only be annulled upon a direct appeal therefrom to the appropriate appellate tribunal. Such a judgment, though void, cannot be collaterally attacked in any other proceeding or in any other jurisdiction. Consequently, to avoid any possible prejudice to Dragor in the future, it is compelled to seek, by this appeal, a corrective decree of this Court expunging the void judgment of the District Court herein.

### **The Issues Presented by This Appeal**

This appeal presents for this Court's review the validity of the second judgment entered by the Arizona District Court in this case on December 7, 1965 dismissing the compulsory counterclaim contained in the answer which Dragor had been compelled to file after the District Court had erroneously denied its motion to quash the service of process and dismiss the complaint. Since this Court has already ruled by its judgment of reversal on April 7, 1966 that the District Court did not possess, never acquired, and could not constitutionally exercise any jurisdiction over the person of Dragor, it is plain that the judgment entered by the District Court on December 7, 1965 was totally void and must be annulled.

To apprehend the factual and legal scope of the issues posed by this appeal, we turn to a review of the proceedings before the Court below.

### **1. *The District Court's Erroneous Assumption of Jurisdiction In Personam***

The facts which established the Arizona District Court's unconstitutional assumption of jurisdiction *in personam* in this case, commencing with its erroneous refusal on February 2, 1965 to grant Dragor's motion to quash the service of process and dismiss the complaint, have been so fully set forth by this Court in its opinion of April 7, 1966 that no repetition thereof is necessary at this point. We shall limit our discussion of the facts to the manner in which the District Court continued to perpetuate its initial error which ultimately resulted in the entry of the void judgment of December 7, 1965 presented for review herein.

### **2. *Dragor's Continuous and Unsuccessful Efforts (a) to Procure a Review, by Interlocutory Appeal, of the District Court's Unconstitutional Assumption of Jurisdiction and (b) Avoid the Necessity of Filing an Answer Containing a Compulsory Counterclaim***

Subsequent to the District Court's denial of its motion to quash for lack of jurisdiction, Dragor moved promptly to modify the order denying the motion to vacate by adding recitals thereto which would have permitted an interlocutory appeal to this Court pursuant to 28 U. S. C. §1292(b).<sup>2</sup>

As appears from the affidavit of Dragor's president submitted in support of the application, Dragor was apprehensive that its jurisdictional objections might be jeopardized by being compelled to file an answer to the complaint which would have to include, under Rule 13, F.R.C.P., a compulsory counterclaim against Union for the damages which it had sustained as a result of Union's breach of its

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<sup>2</sup> This fact was noted by this Court in its opinion upon the prior appeal at 361 Fed. (2d), p. 45.

fiduciary obligations under the New York settlement agreement and covenant not to sue. The grounds for the motion to modify were explicitly stated by Dragor's president in his supporting affidavit as follows (R. 1, pp. 89-90) :

“Consequently, Ward has no other recourse than to assert the total damages which it has sustained by virtue of Union's breach of its fiduciary obligations, as a compulsory counterclaim in this case.

It is precisely this situation which makes necessary the certification requested by Ward upon this motion.

\* \* \* \*

Under Rule 13(a), Ward will be compelled, if the action continues in this Court, to file its counterclaim as a compulsory counterclaim. If it does not do so, that counterclaim may be deemed forever waived. *If such a counterclaim is filed, I am advised by counsel that the interposition thereof, even though it be a compulsory counterclaim, may automatically constitute a waiver of any objections to the jurisdiction of this Court over the person of the defendant which may be set forth in the answer or which may have been taken previously by motion.* If, therefore, Ward's jurisdictional objections are deemed waived by the interposition of a compulsory counterclaim which Ward would be compelled to assert, it would, therefore, become impossible to present those jurisdictional objections to the Circuit Court of Appeals after a final judgment in this case. Thus, the final judgment in this case would operate to deprive Ward of its right to review and give it no opportunity to appeal from the order denying its motion to quash.

Ward's only remedy, obviously, is the present motion requesting the Court to certify the question to the Circuit Court of Appeals at this time in order that it may



have what every litigant is entitled to receive, a right of review of a serious jurisdictional and constitutional issue which it would otherwise be compelled to waive.” (Italics ours.)

Dragor’s motion to amend the order of the District Court to permit an application to this Court for leave to appeal therefrom was vehemently opposed by Union as “frivolous” (R. 1, p. 76), although it conceded that a “reversal of the court’s order sustaining the service of process would terminate litigation . . .” (R. 1, p. 76). Before the District Court, *Union insisted that Dragor’s involuntary interposition of a compulsory counterclaim could not possibly constitute a waiver of its jurisdictional objections.* The District Court apparently accepted Union’s arguments upon this score and denied Dragor’s motion to amend its order on March 1, 1965, thereby shutting off any possibility of an application to this Court under 28 U. S. C. §1292(b).<sup>3</sup>

Still apprehensive, Dragor filed an application for a writ of prohibition in this Court. In that application, it reiterated its concern that the interposition of a compulsory counterclaim in its answer, though involuntary, might be deemed a waiver of its jurisdictional objections. It sought a prompt determination of those objections “without risk of waiver by petitioner-defendant, and with judicial economy.” Its views were expressed in its Statement of Points and Authorities (pp. 11-12) as follows:

“Petitioner-defendant believes that it has valid grounds to recover damages from respondent-plaintiff for breaches by respondent-plaintiff of fiduciary duties and obligations owed to petitioner-defendant. Peti-

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<sup>3</sup> The District Court’s denial of the motion to modify its prior order was noted by this Court in its opinion upon the prior appeal at 361 Fed. (2d), p. 45.



tioner-defendant's claims arise under said Agreement Of Settlement, and must be asserted by compulsory counterclaim in said action, under the requirements of *Rule 13 (a) Federal Rules of Civil Procedure*.

*Hancock Oil Co. v. Universal Oil Products Co.*  
115 F. 2d 45 (9 Cir. 1940).

\* \* \* \* \*

*Under the circumstances, petitioner-defendant should not be required to incur the risk that the filing of its counterclaim would estop and preclude petitioner from preserving and raising its jurisdictional objections by appeal, or otherwise, after final judgment. Such jurisdictional objections can properly and promptly be determined at this time, without risk of waiver by petitioner-defendant, and with judicial economy."* (Italics ours)

In opposing the petition, Union derided Dragor's fears. At page 3 of its Statement of Points and Authorities submitted to this Court in opposition to Dragor's motion for leave to file a writ of prohibition, it phrased the issue presented by the motion as follows:

"3. Whether the drastic and extraordinary remedy of prohibition or mandamus may be invoked in order to secure an advisory opinion from this Court that the pleading of a proposed compulsory counterclaim will not constitute a waiver of petitioner's personal jurisdiction objection—a *question with respect to which there is no conflict of authority.*" (Italics ours.)

Union formally assured this Court, in the most absolute of terms, that the waiver which Dragor feared could not possibly be effected by the filing of a compulsory counterclaim, *particularly where as here, Dragor was being "co-*

*erced*" into the service of its answer. Thus, Union argued in its Point III as follows:

**"Petitioner's Erroneous Compulsory Counterclaim Contention Constitutes No Special Circumstance Warranting Allowance of the Present Motion**

Dragor would invoke the extraordinary remedy jurisdiction of this Court in order to secure an advisory opinion whether its pleading of a proposed counterclaim in this action would constitute a waiver of its personal jurisdiction objection so as to preclude orderly review thereof pursuant to 28 U. S. C. §1291. A supposed ambiguity in the law in this regard is asserted as a special circumstance warranting immediate consideration of the question by way of prohibition or mandamus petition.

*No such ambiguity exists for the authorities hold without exception that the pleading of a compulsory, as distinguished from a permissive, counterclaim constitutes no waiver of a previously asserted jurisdictional defense.*

A careful analysis of this very question is found in Barron & Holtzoff, Federal Practice and Procedure, Vol. 1A, §370.2, where it is stated, at p. 535:

*'What has been said so far deals only with the situation in which the counterclaim is permissive, and where there is some justice in saying that defendant, by voluntarily invoking the jurisdiction of the court on his counterclaim, must be held to have waived his objections to jurisdiction or venue. To apply such reasoning to compulsory counterclaims would be quite a different matter, since there defendant has no choice but is coerced into asserting his claim as a counterclaim . . . Thus there is merit in those cases*

which have drawn a distinction, and which have held that the assertion of a compulsory counterclaim is not a waiver of other defenses and objections joined with it.’

The Tenth Circuit quoted and approved the conclusion stated in the *Barron & Holtzoff* treatise in *Hasse v. American Photograph Corporation*, 299 F.2d 666 (C. A. 10, 1962). In a square holding on the point here in question the court declared at p. 668-9:

‘. . . To hold that the defense of lack of jurisdiction of the person is waived by asserting a compulsory counterclaim would do violence to the purpose of Rule 12 in negating the necessity of special appearances.

‘Since appellant had no alternative but to submit his claim against the plaintiff along with his defense to appellee’s complaint, *we hold that such compulsion did not constitute a waiver of his jurisdictional defense.*’” (Italics ours)

Apparently persuaded by Union’s arguments, this Court denied the application for leave to file a petition for a writ of prohibition on March 22, 1965.<sup>4</sup>

### **3. *Dragor’s Answer and Compulsory Counterclaim***

Having exhausted every possible method available under the law of procuring an interlocutory review of the District Court’s erroneous jurisdictional ruling, Dragor was compelled to file its answer and compulsory counterclaim, under penalty of default or loss if it did not do so. In its answer, Dragor, still concerned, reasserted as its second

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<sup>4</sup> This fact was noted by this Court in its opinion upon the prior appeal at 361 Fed. (2d), p. 45.



defense its claim that the District Court had never acquired jurisdiction over its person (R. 1, pp. 96-97).<sup>5</sup> It then set forth its compulsory counterclaim predicated upon Union's breach of the New York settlement agreement and covenant not to sue, alleging as part and parcel of that compulsory counterclaim the following in paragraph 18 thereof (R. 1, pp. 104-105):<sup>6</sup>

“ \* \* \* that, to avoid a default in answering, the defendant herein has been compelled to file this counterclaim as a compulsory counterclaim under the Federal Rules of Civil Procedure; and that it is now filing the same herein without waiving or intending to waive the objections which it has heretofore raised and asserted, and has herein alleged, to the jurisdiction and venue of this court.”

The answer was interposed on March 22, 1965. The application for leave to file a petition for a writ of prohibition was denied later that day, on March 22, 1965.

#### ***4. Union's Motions for Judgment on the Complaint and to Dismiss the Counterclaim***

Thereafter, Union moved for judgment on the complaint, as well as for a dismissal of the compulsory counterclaim as insufficient in law, even before it filed its reply. Its motion to dismiss the compulsory counterclaim was denied. Its motion for judgment on the complaint was granted. A judgment in favor of Union against Dragor in the sum of \$1,037,500. was made and entered by the District Court on

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<sup>5</sup> The defense set forth in Dragor's answer, that the District Court lacked jurisdiction *in personam*, was noted by this Court in its opinion upon the prior appeal at 361 Fed. (2d), p. 45.

<sup>6</sup> These allegations of the compulsory counterclaim were noted by this Court in its opinion upon the prior appeal, 361 Fed. (2d), p. 45, footnote 2.



June 1, 1965, the judgment which this Court reversed on April 7, 1966 upon the ground that the District Court never acquired and could not constitutionally exercise any jurisdiction over the person of this defendant.

### **5. *Union's Action in the Federal District of Connecticut***

Subsequent to the entry of the judgment for \$1,037,500. and on or about June 29, 1965, Union brought an action in the United States District Court for the District of Connecticut against Jakob Isbrandtsen, a resident of the State of Connecticut and the guarantor under a guaranty executed and delivered in New York of Dragor's obligations upon the New York settlement agreement and non-negotiable promissory note issued thereunder. (R. 2, pp. 68; 76-82). In that action, Isbrandtsen filed an answer denying any liability to Union under his guarantee (R. 2, pp. 83-99), and, in addition thereto, under Rule 14(a) of the Federal Rules of Civil Procedure, a third party complaint against Dragor demanding that he be reimbursed by Dragor for any sum or sums for which he might be held liable to Union. (R. 2, pp. 100-101). Dragor thereupon filed its answer which contained, likewise under Rule 14(a), a denial of any liability to Isbrandtsen or Union and a cross claim against Union in which it set forth its claim for damages predicated upon Union's breach of the New York settlement agreement and covenant not to sue, the precise cause of action which it had been forced to set forth as a compulsory counterclaim in the Arizona suit. (R. 2, pp. 116-136).

Union then moved before the Arizona District Court, by a notice of motion, returnable on September 13, 1965, for an order "enjoining the defendant (Dragor) from proceeding, until further order of this Court, in civil action #11011 entitled 'Union Tank Car Company v. Jakob Is-

brandtsen, Defendant and Third-Party Plaintiff v. Dragor Shipping Corporation, Third-Party Defendant' which action is now pending in the District Court for the District of Connecticut." (R. 2, pp. 65-71; 159). Isbrandtsen thereupon moved in the Connecticut District Court, on October 15, 1965, for an order of that Court enjoining and restraining both Union and Dragor from proceeding with the prosecution of the compulsory counterclaim in this Arizona action (R. 2, p. 159).

**6. *Dragor's Motion for Leave to Discontinue Its Compulsory Counterclaim Without Prejudice***

Faced, on the one hand, with a threatened injunction in the Arizona suit against the assertion of its defenses and the prosecution of its cross-claim in the Connecticut action, and, on the other hand, with an injunction by the Connecticut District Court against the prosecution of its compulsory counterclaim in the Arizona suit, Dragor thereupon moved in this action before the Arizona District Court for an order under Rule 41(a) and (c) of the Federal Rules of Civil Procedure discontinuing its "coerced" counterclaim in the Arizona suit without prejudice. (R. 2, pp. 146-165). It pleaded, in support of its application to discontinue the compulsory counterclaim without prejudice, that, were it successful in its then pending appeal to this Court, "all of the proceedings in this Court will be nullified *ab initio*." (R. 2, p. 149). It argued additionally as follows (R. 2, pp. 161-163):

"1. The set-off and counterclaim in this action suffers from a jurisdictional taint which will invalidate all of the proceedings in this Court, if Dragor is successful in its appeal from this Court's rulings. No such taint clouds the jurisdiction of the Connecticut District Court.

2. Jakob Isbrandtsen is not a party to this action and has never had an opportunity to be heard in his own defense by attorneys of his own choice and selection. He is a party to the Connecticut action. Consequently, in the Connecticut District Court, a forum chosen by the plaintiff itself, all of the necessary parties are before a single tribunal, which has unquestioned jurisdiction, power and authority to dispose in one action of all of the issues presented by all of the parties to the existing controversies.

3. Union is a defendant under Dragor's set-off and counterclaim in this action, the only affirmative pleading remaining before this Court. It is likewise a defendant to the cross-claim asserted by Dragor in the Connecticut action. No defendant has a right to determine in which of two tribunals he may be sued, particularly where he has himself invoked the jurisdiction of both and the jurisdiction of one has been continuously and vehemently protested by the other.

4. Finally, neither Isbrandtsen nor the issues between Union and Isbrandtsen and Isbrandtsen and Dragor are before this Court and can never be before this Court. All of the parties and all of the issues, including the issues between Union and Dragor under the counterclaim, are presently before the Connecticut Court which can, by a single adjudication in a single trial binding upon all of the parties thereto, resolve all of the existing controversies. In the language of the United States Supreme Court in *Kerotest Manufacturing Co. v. C-O Two Fire Equip. Co.*, 342 U. S. 180: *'The Chicago (in this case Connecticut) suit when adjudicated will bind all the parties in both cases. Why should there be two litigations where one will suffice? We can find no adequate reason.'*" (Italics ours)



Upon the argument for leave to discontinue, the District Court declared that, even if this Court should reverse the judgment of \$1,037,500. which had been previously entered against Dragor upon the ground that the District Court never acquired any jurisdiction *in personam*, it intended, nevertheless, to proceed with a trial of the compulsory counterclaim which Dragor had been forced to file.

The District Court thereupon denied Dragor's motion for leave to discontinue without prejudice (R. 2, p. 232). As a result, Dragor became convinced that any further participation by it in the proceedings before the Arizona District Court might irreparably jeopardize its claim that the Arizona District Court never acquired jurisdiction over its person in this action. Consequently, upon the advice of counsel,<sup>7</sup> it refused to proceed any further (R. 2, pp. 204-206), confident that its position would be sustained upon appeal. On December 7, 1965, the District Court dismissed the compulsory counterclaim "for failure of defendant and

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<sup>7</sup> As this Court was advised upon Dragor's application for leave to file a writ of prohibition (Statement of Points and Authorities, pp. 11-12), Dragor's counsel were acutely aware of the fact that no definitive decision had been rendered by this Court in this area of the law. In their view, the District Court's insistence upon an immediate trial of the compulsory counterclaim upon the merits, no matter how this Court might rule upon the then pending appeal, in conjunction with the decision of the Fifth Circuit in *Haberman v. Equitable Life Assurance Society of the United States*, 224 Fed. (2d) 401 (1955), threatened the preservation of the constitutional objections upon which Dragor had so painstakingly insisted. In *Haberman*, the Fifth Circuit had ruled as follows, at p. 409:

"That counterclaim was a compulsory counterclaim under Rule 13(a), Federal Rules of Civil Procedure, \* \* \* Consequently, whether or not Equitable had the capacity to bring this action, *this court has and the court below had, jurisdiction, Haberman having allowed the action and counterclaim to go to final judgment on the merits.*" (Italics ours.)

Consequently, counsel were fearful that, if Dragor participated in a trial of its compulsory counterclaim upon the merits, it might thereby be deprived of its right thereafter to press its constitutional objections to the *in personam* jurisdiction of the District Court.



cross-claimant to prosecute the same . . .” (R. 2, p. 207).<sup>8</sup> Dragor thereupon promptly appealed to this Court from the aforesaid judgment.<sup>9</sup> (R. 2, p. 208).

### **Specification of Errors**

1. This Court’s judgment of April 7, 1966, conclusively and finally adjudicated the District Court’s lack of jurisdiction over the person of Dragor. Consequently, the District Court erred in entering a judgment dismissing the compulsory counterclaim involuntarily filed by Dragor in its answer. The judgment is totally void and must be annulled.

2. The Arizona District Court erred in denying Dragor’s motion for leave to discontinue its compulsory counterclaim without prejudice under Rule 41(a)(2) of the Federal Rules of Civil Procedure.

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<sup>8</sup> The District Court’s dismissal of the compulsory counterclaim, and the then pending appeal from that judgment of dismissal, were noted by this Court in its opinion upon the prior appeal, 361 Fed. (2d), p. 45, footnote 4.

<sup>9</sup> The disposition of Union’s motion in the Arizona District Court and Isbrandtsen’s motion in the Connecticut District Court was as follows: (1) Union failed to press, and virtually withdrew, its motion for an injunction in the Arizona District Court; and (2) with appropriate regard for judicial propriety, Judge Zampano of the Connecticut Federal Court stayed all proceedings by all parties in the Connecticut action until all appeals from the decisions of the Arizona District Court were finally decided.

## A R G U M E N T

### POINT I

**This Court's judgment of April 7, 1966 conclusively established, as *res judicata*, the Arizona District Court's lack of jurisdiction over the person of Dragor in this action. Consequently, the judgment of the District Court dismissing the compulsory counterclaim which Dragor had been compelled to file is totally void and must be annulled.**

"Judicial jurisdiction", declared this Court in *L. D. Reeder Contractors of Arizona v. Higgins Industries*, 265 Fed. (2d) 768, 771, is an indispensable prerequisite to the constitutional validity of juridical action.

This Court's judgment of reversal on April 7, 1966 constituted a final and definitive adjudication that the Arizona District Court never acquired, and could not lawfully exercise, any judicial jurisdiction over the person of Dragor in this lawsuit. Lacking a constitutional base, all of its orders, judgments and decrees were a total nullity. In the language of this Court in *L. D. Reeder, supra*, at p. 770, "Obviously, a lack of competence of the Court to hear the matter will prevent the entry of a valid judgment."

Had the District Court properly recognized its "lack of competence" and quashed the alleged service of process at the very threshold of these proceedings, the matter would have been completely concluded. Had it permitted an interlocutory appeal under 28 USC §1292 (b), prior to compelling Dragor to file its answer and compulsory counterclaim, the matter would likewise have been concluded. In Union's own language, "a reversal of the court's order sustaining the service of process would terminate litigation . . ." (R. 1,

p. 76). The District Court's initial error, perpetuated thereafter, culminated in a second judgment which, as in the case of the first judgment, was totally void, without any constitutional, jurisdictional or due process foundation therefor whatsoever.

**A. *This Court's Judgment of April 7, 1966 Has Conclusively Determined, as res judicata, the District Court's Lack of Jurisdiction Over the Person of Dragor in This Case***

On April 7, 1966, this Court reversed the judgment entered by the District Court on June 1, 1965 upon the ground that the District Court never acquired any jurisdiction over the person of Dragor.

From the very inception of these proceedings, Dragor has resolutely and steadfastly refused to acknowledge, accept or submit to the *in personam* jurisdiction of the Arizona District Court. The record of that continuous refusal, and Dragor's meticulous preservation of its constitutional objections to the *in personam* jurisdiction of the District Court under Rule 12 of the Federal Rules of Civil Procedure, are crystal clear. This Court's judgment of reversal, predicated squarely upon the ground that the Arizona District Court never acquired any jurisdiction over the person of Dragor, is *res judicata* upon this appeal. It constitutes a final, conclusive and binding determination that the Arizona District Court did not possess and never obtained any jurisdiction over the person of Dragor in this lawsuit. "The principles of *res judicata* apply to questions of jurisdiction as well as to other issues." (*American Surety Co. v. Baldwin*, 287 U.S. 156, 166, 53 Sup. Ct. 98).

Every material fact, circumstance, principle of law and argument necessary to a resolution of that issue was before this Court upon the prior appeal. None of them, singly or



collectively, were ever deemed to constitute, even argumentatively, a submission by Dragor to the *in personam* jurisdiction of the Court below. Among those facts were the following:

1. Subsequent to the purported service of process, Dragor appeared specially to quash that service and dismiss the complaint upon the ground that the Arizona District Court could not constitutionally acquire thereby jurisdiction over the person of this defendant (361 Fed. (2d) 43, 45).

2. Upon the denial of that motion, Dragor moved to modify the District Court's Order by adding recitals thereto which would permit an interlocutory review by this Court under 28 U. S. C. §1292 (b) (361 Fed. (2d) 43, 45).

3. After the District Court denied the motion to amend, Dragor moved in this Court for leave to file a petition for a writ of prohibition restraining the District Court from proceeding with the action in that Court. The application was denied (361 Fed. (2d) 43, 45).

4. Thereafter, Dragor was compelled to file an answer which reiterated its defense that the Arizona District Court did not possess jurisdiction over its person (361 Fed. (2d) 43, 45).

5. In its answer, Dragor was compelled to assert a compulsory counterclaim which alleged that Union had breached the New York settlement agreement and covenant not to sue. In setting forth its compulsory counterclaim, Dragor specifically stated that, to avoid a default in answering, it had been compelled to file the counterclaim as a compulsory counterclaim, and that it did so "without waiving or intending to waive the objections which it had theretofore raised and asserted, and had alleged in its answer . . . to the juris-



diction and venue of this court” (361 Fed. (2d) 43, 45, footnote 2).

6. Subsequent to the entry of the judgment upon the complaint, and for the reasons more specifically set forth above, Dragor moved for leave to discontinue its compulsory counterclaim without prejudice, alleging, as one of the grounds therefore, that the *in personam* jurisdiction of the District Court was the subject of an appeal to this court and that, were Dragor successful, “all of the proceedings in this court will be nullified *ab initio*” (R. 2, p. 149; Dragor’s Reply Brief, Appeal No. 20416, pp. 18-19).

7. On December 7, 1965, the date specified by the District Court for the trial of the compulsory counterclaim, a judgment was entered dismissing the counterclaim for lack of prosecution. Dragor’s appeal from the order granting such judgment was pending at the time that the first appeal in this cause was argued and decided (361 Fed. (2d) 43, 45, footnote 4).

It is impossible to conceive of a more adamant and continuously asserted objection to the jurisdiction of the District Court than that presented to this court by the record herein. It is equally impossible to conceive of a more meticulous preservation of those constitutional objections by a litigant than the steps taken by Dragor in this action under Rule 12 of the Federal Rules of Civil Procedure. In Moore’s Federal Practice, Rules Pamphlet, Civil Rules—Official Forms, as amended 1966, the commentators declared of the current revisions to Rule 12:

“Rule 12(b) has not changed the federal doctrine that where a defendant properly presents his defenses, on an appeal from an adverse judgment on the merits all the defenses raised by him, both matter in bar and

matter in abatement involving jurisdiction (cf. 28 USC §2105), are open to him. Thus, for example, if he has properly challenged lack of jurisdiction over his person by a motion under Rule 12(b) (2), and this motion is overruled by the district court, the defendant may plead to the merits and on appeal from a judgment for the plaintiff raise lack of jurisdiction over his (the defendant's) person as well as matter going to the merits, and if the defendant is sustained as to his matter in abatement, the judgment on the merits will be reversed with directions to dismiss the action. Paragraph 12.12."

The authorities are completely in accord with the foregoing principles. They include the very authorities which Union had successfully invoked when it had induced both this Court and the District Court to deny Dragor's protracted efforts to procure an interlocutory review of the District Court's refusal to quash the service of process before it was forced to file its compulsory counterclaim herein. In the very language employed by Union before this Court upon Dragor's motion for leave to file a writ of prohibition, "the authorities held *without exception* that the pleading of a compulsory, as distinguished from a permissive, counterclaim, constitutes no waiver of a previously asserted jurisdictional defense." Union contended at that time that "The pleading of a proposed compulsory counterclaim will not constitute a waiver of petitioner's personal jurisdiction objection" is "a question with respect to which there is *no conflict of authority*."

*Hasse v. American Photograph Corporation*, 299

Fed. (2d) 666 (10th Circ., 1962);

*North Branch Products, Inc. v. Fisher*, 284 Fed.

(2d) 611 (Ct. of Appeals, D. C., 1960);

*Davis v. Ensign-Bickford Co.*, 139 Fed. (2d) 624

(8th Circ., 1944);

*Blank v. Bitker*, 135 Fed. (2d) 962 (7th Circ., 1943);  
*Sadler v. Penn. Refining Co.*, 33 Fed. Supp. 414 (1940);  
*Beaunit Mills, Inc. v. Industrias Reunidas F. Matarazzo*, 23 F. R. D. 654, 657 (S. D. N. Y. 1959);  
*Barron & Holtzoff, Federal Practice and Procedure*, Vol. 1A, §370.2, p. 535).

In accordance with the foregoing decisions, it is indisputably clear that, by its decision of April 7, 1966, this Court had unequivocally ruled that the Arizona District Court did not possess any jurisdiction over the person of Dragor, that it lacked any constitutional power or competence to enter a valid judgment in this cause, and that its initial judgment in favor of Union was totally void.

“An adjudication bars future litigation between the same parties not only as to all issues actually raised and decided but also as to those which could have been raised. . . .” (*Angel v. Bullington*, 330 U. S. 183, 186, 187; 67 Sup. Ct. 657, 1947).

It follows then, as night the day, that the Arizona District Court’s second judgment dismissing Dragor’s compulsory counterclaim for want of prosecution is equally as void as its first judgment and must likewise be annulled upon this appeal.

**B. *The District Court’s Judgment Dismissing Dragor’s Compulsory Counterclaim is Void.***

It is fundamental learning that the judgment of a Court which lacks jurisdiction *in personam* is a total nullity. The principle is one of ancient lineage. It was



universally applied in Anglo-American law before the adoption of the Fourteenth Amendment to the Constitution.<sup>10</sup> Under that amendment, jurisdiction *in personam* where a personal judgment is sought is an indispensable constitutional requisite of due process (*Pennoyer v. Neff*, 95 U. S. 714).

As the Supreme Court has recently declared in *Hanson v. Denckla*, 357 U. S. 235 at 249:

“Prior to the Fourteenth Amendment an exercise of jurisdiction over persons or property outside the forum State was thought to be an absolute nullity, but the matter remained a question of state law over which this Court exercised no authority. With the adoption of that Amendment, any judgment purporting to bind the person of a defendant over whom the court had not acquired *in personam* jurisdiction was void within the State as well as without, *Pennoyer v. Neff*, 95 U. S. 714.” (Italics ours.)

In *McDonald v. Mabee*, 243 U. S. 90, Justice Holmes stated of a judgment entered without jurisdiction *in personam*:

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<sup>10</sup> That the predicate of jurisdiction *in personam* was absolutely essential to the validity of any personal judgment under Anglo-American law is graphically noted by Judge Sobeloff, “Jurisdiction of State Courts over Non-Residents in our Federal System”, 43 Cornell Law Quarterly, 196 at page 198:

“All within physical reach of this power were subject thereto, and logically, therefore, action affecting persons beyond the court’s geographical area of control was a nullity. These conceptions are epitomized by the famous English case in which the Court of the King’s Bench refused to recognize a personal judgment rendered by the island court of Tobago against a defendant who had never been there. Wrote Lord Ellenborough the now famous words: “Can the island of Tobago pass a law to bind the rights of the whole world? Would the world submit to such an assumed jurisdiction?”



“Whatever may be the rule with regard to decrees concerning status or its incidents, *Haddock v. Haddock*, 201 U. S. 562, 569, 632, an ordinary personal judgment for money, invalid for want of service amounting to due process of law, is as ineffective in the State as it is outside of it. 201 U. S. 567, 568. \* \* \* The personal judgment was not merely voidable, as was assumed in the slightly different case of *Henderson v. Staniford*, 105 Massachusetts, 504, *but was void.*” (Italics ours.)

Again, in *Foster-Milburn Co. v. Knight*, 181 Fed. (2d) 949 (2d Circ.), Judge Learned Hand declared at p. 952:

“It is hornbook law that transitory actions must begin with personal service upon the defendant and that, when they do not, *the judgment is a nullity.*” (Italics ours.)

More recently, in *Vanderbilt v. Vanderbilt*, 354 U. S. 416, Justice Black declared at p. 418:

“It has long been the constitutional rule that a court cannot adjudicate a personal claim or obligation unless it has jurisdiction over the person of the defendant.”

Citing *Vanderbilt v. Vanderbilt*, *supra*, the court in *Hanson v. Denckla*, 357 U. S. 235 underscored the fact, at p. 251, that the constitutional requirement of jurisdiction *in personam* is “a consequence of territorial limitations on the power of the respective States.” Indisputably, then, “if, in fact, there were no service, *the proceedings . . . were void from the very outset.*” (*Williams v. Capital Transit Co.*, 215 Fed. (2d) 487, 490, Ct. App. D. C. 1954).

The United States Supreme Court necessarily held, therefore, in *Kelleam v. Maryland Casualty Company of*

*Baltimore*, 312 U. S. 377 that, the complaint having been dismissed for want of jurisdiction, "no jurisdiction would remain for any grant of relief under the cross-petition" (p. 382). In *Manufacturers Casualty Insurance Company v. Arapahoe Drilling Co.*, 267 Fed. (2d) 5, the Court of Appeals for the 10th Circuit was presented with a set of facts substantially resembling those of the instant case.

In that case, one, Campbell, commenced an action for damages against the Arapahoe Drilling Company. The Manufacturers Casualty Insurance Company entered the case as an intervenor plaintiff because of subrogation rights arising through the payment of workmen's compensation benefits to Campbell. The defendant asserted a counterclaim to the insurance company's complaint alleging that it was an additional insured under a policy issued by the insurance company to Campbell's employer and covering the accident giving rise to the main suit.

The trial court granted a summary judgment dismissing the counterclaim. It then proceeded to a trial of the principal case and discovered, *after the counterclaim had been dismissed upon the merits*, that diversity jurisdiction was lacking for the principal suit. The trial court thereupon dismissed the principal suit for lack of jurisdiction and then proceeded to vacate its prior summary judgment dismissing the counterclaim. The insurance company appealed from a vacatur of the summary judgment.

In affirming, the Circuit Court ruled that the counterclaim could not survive the jurisdictional failure of the complaint. *A fortiori*, where there has been, from the very outset, a total absence of jurisdiction *in personam*, a compulsory counterclaim which a defendant has been coerced into filing cannot, of course, bestow upon the Court which erroneously exerted the compulsion any jurisdiction

over the person of the defendant for any purpose whatsoever.

**C. *A Void Judgment, Entered After an Erroneous Refusal to Quash the Service of Process, Can Only Be Annulled Upon a Direct Appeal to an Appropriate Appellate Tribunal.***

Though the judgment of the District Court dismissing Dragor's compulsory counterclaim herein is totally void, it cannot be ignored. It will not be possible for Dragor to attack that judgment collaterally in any other proceeding or any other jurisdiction. To avoid being prejudiced thereby in any future litigation, it was absolutely essential that Dragor prosecute an appeal from that judgment to this court for a corrective decree expunging it from the record.

The precise issue was presented to the Supreme Court in *Baldwin v. Iowa State Traveling Men's Association*, 283 U. S. 522. In that case, as in this, in a suit commenced in the Federal District Court for Western Missouri, the defendant appeared specially and moved to quash and dismiss for want of proper service. The motion to dismiss was overruled with leave to plead. No pleading was filed, the cause proceeded and a judgment was entered for the amount claimed. The defendant did not move to set aside the judgment or sue out a writ of error.

Thereafter, an action upon that judgment was commenced in the Federal District Court for Iowa. The defendant claimed, as a defense to the second suit, that it had never been served with process in the first action. The plaintiff contended that the defense constituted a collateral attack upon the judgment which was not permissible. The courts below upheld the defendant's contention that the judgment was void for want of personal jurisdiction and



dismissed the action. In sustaining the plaintiff's claim that the judgment of the Iowa District Court, even if void for want of personal jurisdiction, could not be collaterally attacked in the subsequent action, the Supreme Court declared (pp. 524-525):

"The substantial matter for determination is whether the judgment amounts to *res judicata* on the question of the jurisdiction of the court which rendered it over the person of the respondent. It is of no moment that the appearance was a special one expressly saving any submission to such jurisdiction. That fact would be important upon appeal from the judgment, and would save the question of the propriety of the court's decision on the matter even though after the motion had been overruled the respondent had proceeded, subject to a reserved objection and exception, to a trial on the merits. (Citing cases.) The special appearance gives point to the fact that the respondent entered the Missouri court for the very purpose of litigating the question of jurisdiction over its person. It had the election not to appear at all. If, in the absence of appearance, the court had proceeded to judgment and the present suit had been brought thereon, respondent could have raised and tried out the issue in the present action, because it would never have had its day in court with respect to jurisdiction. (Citing cases.) It had also the right to appeal from the decision of the Missouri District Court, as is shown by *Harkness v. Hyde, supra*, and the other authorities cited. It elected to follow neither of those courses, but, after having been defeated upon full hearing in its contention as to jurisdiction, it took no further steps, and the judgment in question resulted.

"Public policy dictates that there be an end of litigation; that those who have contested an issue shall



be bound by the result of the contest, and that matters once tried shall be considered forever settled as between the parties. We see no reason why this doctrine should not apply in every case where one voluntarily appears, presents his case and is fully heard, and why he should not, in the absence of fraud, be thereafter concluded by the judgment of the tribunal to which he has submitted his cause."

Semble:

*Stoll v. Gottlieb*, 305 U. S. 165;

*Allen v. United States Fidelity & Guaranty Co.*,  
342 Fed. (2d) 951 (9th Cir., 1965).

In accordance with the foregoing decisions, Dragor must apply to this Court for a corrective decree expunging the void judgment of the District Court dismissing Dragor's compulsory counterclaim (*U. S. v. Milana*, 148 Fed. Supp. 153). The claims of each of these parties against the other will be litigated in a competent forum at a future date, undoubtedly in the action heretofore commenced by Union against Isbrandtsen in the Federal District Court of Connecticut where all of the parties have asserted their claims and cross-claims. Dragor will be irreparably injured if the District Court's judgment upon the compulsory counterclaim is not annulled and Union is enabled to argue, at such later date, that the void judgment of dismissal has forever foreclosed Dragor from procuring a determination of its cause upon the merits.

***D. The District Court Erred in Denying Dragor's  
Motion for Leave to Discontinue Its Compulsory  
Counterclaim Without Prejudice.***

Under the circumstances presented by the instant case, it is plain that the District Court erred in denying Dragor's

motion for leave to discontinue its compulsory counterclaim without prejudice. After Union's motion for a judgment upon the complaint had been granted, there was no conceivable reason why Dragor should have been forced to continue the compulsory counterclaim which it had been compelled to file over its strenuous objections, particularly where, as here, Union had instituted its action against Isbrandtsen in the Federal District Court of Connecticut and all of the issues presented by the compulsory counterclaim would and could be adjudicated in that suit by a court whose power and competence to do so were unchallenged.

An order of this Court permitting Dragor to discontinue its compulsory counterclaim without prejudice would eliminate completely the deleterious consequences of Union's abortive attempt to invoke the non-existent jurisdiction of the Arizona District Court. It would obviate the certainty that Dragor would be irreparably prejudiced, in another forum, by the claim which Union would there advance that Dragor was forever barred and foreclosed from asserting, as a cross-claim against Union, the cause of action which it had involuntarily set forth in the compulsory counterclaim and which the Arizona District Court itself had upheld as valid and subsisting.

### CONCLUSION

The authors of Rules 12 and 13 of the Federal Rules of Civil Procedure did not intend to create thereby a hidden trap whereby a non-resident, who is being "hauled across the country to defend itself" before a court without jurisdiction over its person (361 Fed. (2d) 43, 49), would be compelled either to forego its jurisdictional objections or waive forever its compulsory counterclaim. Those Rules

were not designed to impale a non-resident upon the horns of so insoluble and cruel a dilemma. To sanction so inequitable a result would constitute an intolerable reproach to the administration of justice. The initial error of the Arizona District Court in refusing to sustain Dragor's constitutional rights cannot possibly be utilized as a means of destroying those rights.

The judgment of the court below must be reversed and the record purged by permitting Dragor to discontinue its "coerced" compulsory counterclaim without prejudice to its constitutional right to a trial thereof upon the merits before a court competent to adjudicate the issues. Any other result would subvert the beneficent purposes of the Federal Rules of Civil Procedure.

It is respectfully submitted that the judgment appealed from be reversed and Dragor be permitted to discontinue its compulsory counterclaim without prejudice.

Respectfully submitted,

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**Certificate of Compliance**

I certify that, in connection with the preparation of this brief, I have examined Rules 18 and 19 of the United States Court of Appeals for the Ninth Circuit, and that, in my opinion, the foregoing brief is in full compliance with those rules.

JOSEPH LOTTERMAN  
Attorney





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No. 20904

IN THE  
**United States Court of Appeals**  
FOR THE NINTH CIRCUIT

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DRAGOR SHIPPING CORPORATION, a corporation,  
formerly Ward Industries Corporation,  
*Appellant,*  
vs.  
UNION TANK CAR COMPANY, a corporation,  
*Appellee.*

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BRIEF OF APPELLEE  
**UNION TANK CAR COMPANY**

Upon Appeal from the District Court of the United States  
for the District of Arizona

---

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UNION TANK CAR COMPANY

**FILED**

OCT 6 1966

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No. 20904

IN THE  
**United States Court of Appeals**  
**FOR THE NINTH CIRCUIT**

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DRAGOR SHIPPING CORPORATION, a corporation,  
formerly Ward Industries Corporation,  
*Appellant,*

vs.

UNION TANK CAR COMPANY, a corporation,  
*Appellee.*

ON APPEAL FROM THE DISTRICT COURT  
OF THE UNITED STATES  
FOR THE DISTRICT OF ARIZONA

---

BRIEF OF APPELLEE  
**UNION TANK CAR COMPANY**

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This is an appeal by defendant-counterclaimant, DRAGOR SHIPPING CORPORATION (Dragor), formerly named Ward Industries Corporation, from a December 7, 1965 judgment entered by the court below dismissing for want of prosecution Dragor's compulsory counterclaim against plaintiff-counterdefendant, UNION TANK CAR COMPANY (Union). The dismissal was caused by Dragor's deliberate refusal to appear before the court below on the December 7 trial date, or to present any evidence in support of its counterclaim, and consequent abandonment of its counterclaim. (R.2, p. 205).<sup>1</sup>

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<sup>1</sup> Union, in this brief, has employed the same record reference system described in Dragor's brief, at p. 2.

## JURISDICTIONAL STATEMENT

Jurisdiction of the court below over the subject matter of Dragor's counterclaim was based on diversity of citizenship, 28 U.S.C., § 1332. Dragor is a Delaware corporation, with its principal place of business in New York. Union is a New Jersey corporation, with its principal place of business in Illinois. The amount in controversy exceeds \$10,000 exclusive of interest and costs. (R.1, p. 105).

Jurisdiction of this appeal is asserted pursuant to 28 U.S.C. §§ 1291 and 2107. Notice of appeal from the December 7, 1965 judgment was filed on December 15, 1965. Dragor filed its opening brief on September 7, 1966. No time extensions were requested by appellant or granted by this Court or the court below.

## STATEMENT OF THE CASE

This appeal arises out of litigation involving Arizona transactions previously considered in part on Appeal No. 20,416, decided by this Court on April 7, 1966, and reported in 361 F.2d 43.<sup>2</sup> The facts concerning inception of the controversy there reviewed in the Court's opinion are equally pertinent here. The facts as stated in Appellant's brief are incomplete and misleading, hence this re-statement of the case.

### **Inception of The Controversy.**

On September 8, 1961, Union entered into a \$16,800,000 first tier subcontract with The Fluor Corporation, Ltd., to provide work and material in connection with the installation of eighteen Atlas Titan missile silos in the vicinity of the Davis-Monthan Air Force Base near Tucson, Arizona. (R.2, pp. 189, 190).

A substantial part of the work undertaken by Union pursuant to its contract with Fluor was in turn subcontracted to a joint venture formed by Dragor and Idaho-Maryland Industries, Inc. (IMI), a California construction firm, pursuant to a \$7,800,000 second tier subcontract executed on October 23, 1961 (R.2, p. 192). During the performance of the work IMI filed a petition under Chapter XI of the Bankruptcy Act in the United States District Court for the Southern District of California, Central Division (R.2, p. 191).

By reason of IMI's bankruptcy and Dragor's refusal to complete the work, Union was forced to take over and complete the joint venture subcontract at a cost which eventually exceeded the joint venture sub-

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<sup>2</sup> Union's petition for writ of certiorari to review the judgment of this Court is now pending before the Supreme Court of the United States (Docket No. 283). This Court, by order dated June 2, 1966, stayed its mandate pending disposition of the certiorari petition.



contract by more than \$9,000,000. In consequence, Union, in May, 1962, filed a diversity action against Dragor in the United States District Court for the Northern District of Illinois, Eastern Division, in order to recover its losses then incurred and in prospect. Dragor appeared and moved to transfer the action to the United States District Court in Tucson, Arizona, on the ground that all matters involved in the action originated in Tucson (R.2, p. 192). After the case was so transferred, Dragor instituted a separate action against Union in the same Arizona District Court, seeking rescission of the construction contract and damages (R.1, pp. 5-8). *Union Tank Car Company v. Ward Industries Corporation*, Civ. No. 1482 - Tuc.; *Ward Industries Corporation v. Union Tank Car Company*, Civ. No. 1478-Tuc.

While these two actions were pending before the Arizona District Court, Mosher Steel Company also sued Dragor and Union in the same court, seeking to recover \$300,000 for fabricated steel sold to the joint venture for use in the joint venture subcontract work. Mosher contended that Union, in addition to Dragor and IMI, was liable for payment either as a co-principal or a guarantor. *Mosher Steel Company v. Fluor Corporation, Ltd., et al.*, Civ. No. 1605-Tuc.

On October 3, 1963, following the completion of discovery and shortly before the date set for trial in Case No. 1482-Tuc. and while Dragor was still licensed to transact business in Arizona, the parties entered into a settlement agreement (R.1, p. 2) to dispose of matters in controversy between them and then involved in the Tucson litigation.

Under the terms of the settlement agreement Union agreed (1) to give Dragor a general release of all claims and demands with the exception of the claim in suit in the Mosher Steel Company case, in connec-

tion with which, as a separate transaction, Dragor was given a covenant not to sue, and (2) to execute and deliver a stipulation to dismiss with prejudice its \$9,000,000 action against Dragor in the United States District Court in Tucson.

Dragor, in turn, agreed (1) to give Union a general release; (2) to cause the dismissal of a suit brought against Union in Los Angeles, California, by the United California Bank as assignee of certain joint venture invoices; (3) to pay Union on or before September 30, 1964, the sum of \$1,000,000, with interest at the rate of Five Percent from January 1, 1964 to the date of maturity, and at the rate of Seven Percent after maturity, the indebtedness to be evidenced by a promissory note payable to Union and to be guaranteed by Jakob Isbrandtsen; and (4) to make an absolute assignment to Union all of the IMI-Ward joint venture's contract adjustment claims against the United States Government, arising out of the Titan II missile launch facility construction work. (R.1, p. 2).

Under the settlement agreement the parties agreed that in the event Union realized in excess of \$7,000,000 from its own contract adjustment claims and the assigned joint venture contract adjustment claims, Dragor would receive 10% (*and Union would retain 90%*) of all claim payments above \$7,000,000 and up to \$12,000,000, and 50% of all claim payments between \$12,000,000 and \$14,000,000. The settlement agreement required (R.1, p. 8) payment of the note on September 30, 1964 even though the claims against the United States government were not finally determined and paid by that date.<sup>3</sup>

<sup>3</sup> The United States Government, acting through the Corps of Engineers, to the present date has never allowed anywhere near \$7,000,000 on the contract adjustment claims. The Corps of Engineers decisions are under appeal by Union and are the subject of pending administrative review proceedings. (R.2, p. 195).



Following settlement of the then pending Tucson litigation between Dragor and Union, the action brought by Mosher Steel Company against Dragor and Union came on for non-jury trial before the United States District Court in Tucson. Prior to the trial, Union, although denying any liability in the action, but realizing that Mosher was seeking to hold it liable for the obligation of Dragor, obtained leave to file a counterclaim against Mosher praying that (1) the court determine whether a principal-surety relationship existed between Ward and Union with respect to the Mosher claim, and (2) that in the event such relationship was found to exist, and Union and Ward were each held liable to Mosher, that Plaintiff be compelled first to seek satisfaction on its claim from Ward, as the defendant primarily responsible for payment. Dragor, although not a party to the counterclaim, unsuccessfully sought to dismiss the same on the ground that it constituted a breach of Union's covenant not to sue delivered pursuant to the settlement agreement.<sup>4</sup>

On April 30, 1964, seven months after executing the \$1,000,000 note and settlement agreement, Dragor obtained permission from the Arizona Corporation Commission to surrender its license to transact business in Arizona "except as to creditors." (R.1, p. 25). On September 30, 1964, Dragor defaulted in payment of the \$1,000,000 note indebtedness and has never paid one cent on its nine million dollar debt to Union on the subcontract or on the note given in settlement thereof. (R.1, p. 3).

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<sup>4</sup> On May 24, 1966, the court below entered judgment in favor of Mosher and against Dragor and Union in the amount of \$268,882.92. On June 20, 1966, the Court below entered a further judgment that Union take nothing by its counterclaim. Both defendants have filed notice of appeal.

### **Institution of This Action.**

As a result of the default, Union filed this action against Dragor Shipping Corporation on December 23, 1964. The complaint alleged that Dragor had defaulted in payment of the sum of \$1,000,000 and interest under the promissory note and agreement settling claims between the parties which arose out of the construction work performed in the State of Arizona (R.1, p. 2). Service of process was made upon Dragor by delivering copies of the summons and complaint both to Dragor's registered agent, C. T. Corporation, and to the Arizona Corporation Commission (R.1, pp. 12-14).

On January 12, 1965, Dragor appeared specially and filed a motion to quash service of process and dismiss the complaint on the ground that the District Court had not obtained jurisdiction over its person through the service of the process employed (R.1, p. 15). The motion to quash and dismiss was denied by the trial court on February 2, 1965 (R.1, p. 182). Judge Walsh then refused to certify his order for interlocutory review (R.1, p. 182), and Dragor unsuccessfully sought leave of this court to file a petition for writs of prohibition and mandamus (C.A. No. 19932).

### **Dragor's Answer and Counterclaim.**

Dragor thereupon filed its answer to the complaint on March 22, 1965. The answer did not deny default and non-payment of \$1,000,000 note indebtedness to Union, but reasserted the jurisdictional objection as an affirmative defense, stating that the court below was without "power or authority to determine or adjudicate the claims asserted by the plaintiff herein against this defendant." (R.1, p. 97). Dragor then pleaded the instant counterclaim, which it claims was



“a compulsory counterclaim under the Federal Rules of Civil Procedure.” (R.1, p. 105).

The counterclaim alleged that Union had improperly prosecuted its claims (including those assigned by the joint venture) for equitable adjustment against the United States Government, in which claims Dragor alleged it had a contingent financial interest under the terms of the settlement agreement.<sup>5</sup> It also alleged that Union had breached the covenant not to sue given Dragor pursuant to the settlement agreement by filing the above-described counterclaim against Mosher, and by engaging in acts adverse to Dragor’s interest in the Mosher Steel Company litigation.<sup>6</sup> In its prayer for relief Dragor demanded (R.1, p. 105):

“An affirmative judgment against the plaintiff for the sum of not less than \$1,000,000, together with appropriate interest thereon and such additional damages as may be ascertained and

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<sup>5</sup> Dragor alleged that Union had breached the agreement: “(a) By changing and altering the defendant’s claims without the knowledge or consent of the defendant . . . (b) By failing to promptly, efficiently, competently and expeditiously file and prosecute the plaintiff’s claims . . . (c) By failing to efficiently, competently and diligently assemble, collate and submit the evidence necessary to support such claims . . . (d) By failing to competently, efficiently and diligently press for redetermination, reviews and appeals . . . (e) By failing to diligently, efficiently and competently assemble, collate and submit the evidence necessary to support applications for such redeterminations, reviews and appeals . . . (f) By failing to exercise the degree of care, skill, diligence and competence necessary for the collection of the moneys due upon such claims . . . (g) By failing and refusing to advise the defendant of the manner in which it had filed and prosecuted said claims . . . (h) By failing and refusing to account to the defendant for the moneys, if any, collected . . .” (R.1, p. 101).

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<sup>6</sup> In this regard the counterclaim alleged: “16. That, in breach and violation of the aforesaid ‘Covenant Not To Sue,’ and subsequent to the execution and delivery thereof, the plaintiff herein, by its acts in the aforesaid action, including the filing of amended pleadings and a counterclaim against the plaintiff, Mosher Steel Company, as well as by its memorandum of facts and law, continuously and persistently pursued this defendant by alleging, asserting and arguing that this defendant was liable to the said Mosher Steel Company for the full amount of its claim and continuously and persistently sought to have the Court impose upon this defendant a liability to the said Mosher Steel Company for the said amount; and that the acts so committed and performed by this plaintiff, in violation of the obligations set forth and contained in the aforesaid ‘Covenant Not To Sue,’ constituted a further breach of the said settlement agreement.” (R.1, p. 103).

determined during the course of this action, including the costs and disbursements thereof.”<sup>7</sup>

### **Dragor's Use of Counterclaim in Effort to Prevent Judgment on the Pleadings.**

On April 7, 1965, Union filed a motion for judgment on the pleadings on the ground that defendant's answer failed to state a defense to Union's claim for relief (R.1, p. 110). Dragor's answer had failed to deny execution of the settlement agreement and promissory note, the consideration therefor, the amount of its note indebtedness, the maturity date, or its failure to pay. Plaintiff contended that under these circumstances, Union was entitled to judgment on its claim for relief, and also requested that, in the event the court found merit in its motion, that consideration be given to certification of any judgment pursuant to F.R.C.P. Rule 54(b) (R.1, pp. 110, 114, 137).

Dragor opposed this motion by contending that it was entitled to a determination of its counterclaim before any judgment could be entered with respect to plaintiff's claims for relief. Dragor stated in its memorandum (R.1, p. 148):

“The courts have repeatedly ruled that neither a motion for judgment on the pleadings nor a motion for summary judgment will lie where a defendant has set forth a valid and subsisting counterclaim in its answer which equals, or exceeds, the amount of the plaintiff's claim.”

The court below rejected this contention. On June 1, 1965, Judge Walsh granted plaintiff's motion and

<sup>7</sup> Note that by reason of the settlement agreement formula, (R.1, p. 100) Dragor would have been required to prove that Union, but for its conduct, would have received fully \$13,000,000 in claims payments in order to entitle Dragor to \$1,000,000. The incredible character of Dragor's counterclaim is apparent from the fact that Union would have had to deliberately destroy 90% of its claims in order to deprive Dragor of its 10% share.



ordered entry of a judgment in favor of Union for \$1,037,500. (R.1, p. 151).

**Dragor's Opposition to Rule 54(b) Certification.**

The court below, upon granting judgment on the pleadings, certified the judgment as final, pursuant to the provisions of F.R.C.P. Rule 54(b). Dragor thereby was afforded the immediate appeal on its service of process objection which it had previously sought prior to filing its counterclaim. Nevertheless, Dragor contested and opposed certification.

Even after Rule 54(b) certification had been granted, Dragor persisted in its objection. It contended that certification was error because defendant had not yet been afforded a trial on the merits, and an opportunity to secure an affirmative judgment against plaintiff on its counterclaim even though Dragor now says the counterclaim was in the case only under "compulsion" of the rules and was *void ab initio*. In its statement of points on appeal from the June 1 Judgment, Dragor asserted (R.1, p. 170):

**"VIII**

The United States District Court for the District of Arizona erred in making and entering said final judgment of June 1, 1965, after denying the plaintiff's motion to dismiss the defendant's Set-Off and Counterclaim, because said judgment was made and entered prior to a trial of the merits of the action. . ."

**Dragor's Motion to Stay Enforcement of June 1, 1965 Judgment.**

Dragor next filed a motion on June 10, 1965, pursuant to F.R.C.P. Rule 62(h), to stay enforcement of the June 1 judgment. As grounds for the motion Dragor again urged that it possessed a counterclaim which the Court had ruled stated a valid and subsist-

ing claim for relief, (R.1, pp. 58-9). Under these circumstances, Dragor asserted that it was entitled to have stayed "enforcement of said judgment for plaintiff against defendant *until the entering of a subsequent judgment on defendant's setoff and counterclaim.*" (R.1, p. 161.) (Emphasis added.)

Judge Walsh, following briefing and oral argument, denied the motion for a stay of enforcement on June 28, 1965. One week later, on plaintiff's motion, he set the counterclaim for trial on December 7, 1965 (R.1, pp. 152, 184). Not content with this disposition, Dragor contended that Judge Walsh had abused his discretion and erred in not staying execution of the judgment on the note until after Dragor could secure an adjudication of its counterclaim. In its statement of points on appeal filed in this Court, Dragor declared (R.1, p. 193):

"The United States District Court for the District of Arizona abused its discretion and erred in overruling and denying defendant's motion filed on June 10, 1965, under Rule 62(h), Federal Rules of Civil Procedure, to stay enforcement of said final judgment of June 1, 1965, and in making and entering its order of June 28, 1965, which overruled and denied same, in that, as more particularly appears on the face of said motion and defendant's memorandum of points and authorities attached thereto, said Court by its order, made and entered on June 1, 1965, acknowledged, upheld, and ruled that defendant's Set-Off and Counterclaim is legally sufficient, and left the issues raised therein and by plaintiff's reply thereto for future determination and subsequent judgment herein, and no reason or just cause appeared, or appears why defendant's said motion should not be granted and allowed."

In repeatedly demanding and insisting upon a trial of the counterclaim by the court below, Dragor



never asserted, contended, or even implied that Judge Walsh was without jurisdiction to entertain the counterclaim or to grant the relief which Dragor sought against Union under that pleading. Actually it affirmatively sought the aid of the very court it now says had no jurisdiction and even obtained a ruling by the court below that the counterclaim was legally sufficient.

Dragor did attempt, in its counterclaim, to save its objection to the court's personal jurisdiction over Union's claim against it on the promissory note; but this is not to be confused with the jurisdiction of the court to hear and decide Dragor's claim *against* Union. It is apparent that Dragor could, at any time, have asserted this claim by an original action against Union in the United States Court for the District of Arizona, since all requisites of federal jurisdiction existed, the work was done in Arizona, and Union was doing business there. Union could have had no valid objection to either venue or jurisdiction, had it desired to assert such objection.

### **Dragor's Counterclaim Discovery.**

Dragor not only demanded and insisted upon an opportunity for trial, but was also pursuing a vigorous discovery program on the issues raised by its counterclaim. On the same date, March 22, 1965, that plaintiff filed its answer and counterclaim, Dragor also filed a jury demand and a notice of taking the deposition of plaintiff by its secretary and manager of government contracts (R.1, p. 182). On April 1, it filed a motion for production of documents, filed a statement of points and authorities with respect thereto, and noticed the motion for hearing (R.1, p. 183). At the same time, it filed notices to take the depositions of Robert W. DeBolt, Union's consultant in charge of claims preparation, and of William B.

Browder, Union's general counsel (R.1, p. 183). These depositions were taken by Dragor's counsel and together with bulky exhibits were filed in the court below on May 26, 1965 (R.1, p. 183).

In addition to the hearing on the motion for the production of documents, a hearing was also held on Union's motion to modify the document demands made by Dragor pursuant to subpoena duces tecum (R.1, p. 183). At the hearing a procedure was established for document production, and Union thereafter produced for inspection and copying the hundreds of documents relating to the construction work on the Tucson Missile Launch project which gave rise to claims for an equitable adjustment, and the numerous and bulky documents with respect to the manner in which the claims were prepared and presented to the Contracting Officer and to the Board of Contract Appeals (R.1, p. 183).

#### **Dragor's Motion to Discontinue Counterclaim Without Prejudice.**

After this discovery, Dragor lost all interest in securing an adjudication of its claim for relief. Heretofore, Dragor had been demanding a prompt determination of its counterclaim; now, on October 25, 1965, after the DeBolt deposition had conclusively established that there was no merit in its claim (R.1, p. 184), Dragor filed a motion to dismiss the counterclaim without prejudice (R.2, p. 232) in order to withdraw the same from suit, and thereby to forestall an adjudication thereon.

When demanding an opportunity to try its counterclaim, Dragor had never assumed the position that the court was without jurisdiction to adjudicate and enter a binding judgment on its claim for relief *against* Union. As pointed out above, it had affirma-

tively sought the aid of the trial court, not under duress as it now alleges, but to obtain a million dollar judgment against Union.

Dragor, at the time of filing notice of appeal on June 29, 1965, had refused to post any supersedeas bond to stay enforcement of the June 1 judgment. Union, therefore, was required to institute supplemental proceedings pursuant to F.R.C.P. Rule 69, and an action in the Connecticut District Court against Jakob Isbrandtsen, a Connecticut resident, on his guaranty of Dragor's note indebtedness (R.2, p. 199).

Isbrandtsen, on July 27, 1965, filed an answer to Union's complaint and, at the same time, filed a third party complaint against Dragor ostensibly seeking reimbursement for any amount he might be required to pay Union under his guaranty (R.2, p. 199). Isbrandtsen, individually and through his affiliated companies, owned or controlled about 69% of Dragor's total outstanding voting stock (R.2, p. 200). Dragor, not surprisingly, did not resist being joined as a party to the guaranty action and voluntarily entered its appearance.

Dragor next employed its status as a third party defendant as a means of introducing the Arizona counterclaim into the Connecticut proceedings as a permissive third party claim against Union under F.R.C.P. Rule 14 (R.2, p. 200). After Dragor's Arizona counterclaim was thus injected into the Connecticut proceeding, Isbrandtsen, on October 15, 1965, filed a motion in the Connecticut action seeking to restrain Dragor and Union from proceeding with the trial of the counterclaim pending in the Arizona District Court (R.2, p. 200). However, the District Judge in Connecticut, the Honorable Robert C. Zampano, after hearing arguments, *sua sponte* stayed all pro-



ceedings in the Connecticut action until final disposition of the Arizona controversy.<sup>8</sup>

Only after the Connecticut Court made clear its intention not to enjoin prosecution of the Arizona counterclaim did Dragor, on October 25, seek voluntary dismissal of its counterclaim in the United States District Court in Tucson.

Defendant urged that it should be permitted to discontinue what it described as a “compulsory counterclaim” in order to continue the same as a *permissive* third party claim in Union’s action against Isbrandtsen in the United States District Court for the District of Connecticut, sitting at New Haven. *Union Tank Car Company v. Jakob Isbrandtsen*, Civ. No. 11011.

Union, in opposition to Dragor’s motion, urged that as a straightforward matter of the exercise of judicial discretion, Dragor had advanced no legitimate reason for discontinuing the Arizona counterclaim in order to burden the Connecticut Federal Court with the same litigation.

Union pointed out to the trial court the completion of discovery with respect to the merits of the counterclaim, the pending trial date, the Court’s

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<sup>8</sup> This order does not appear of record in this proceeding, but Dragor conceded the same in its brief at p. 18, Footnote 9. Judge Zampano’s order read in pertinent part: “All proceedings in this Court shall be and they hereby are stayed pending final disposition of the litigation presently pending in the United States District Court for the District of Arizona under the caption *Union Tank Car Company vs. Dragor Shipping Corporation* No. CIV 1967-Tuc., together with the two appeals presently pending in the Court of Appeals for the 9th Circuit which arise out of such case, and together with any other appeals which may be taken in such case, including any other appeals taken to the Court of Appeals for the 9th Circuit, and/or any proceedings including appeals and/or a petition or petitions for a writ of certiorari to the United States Supreme Court, . . .”.

After Dragor effected its entrance into the Connecticut action Union also noticed an injunction motion before Judge Walsh, anticipating that Dragor and Isbrandtsen would seek to shift the scene of the Arizona counterclaim controversy to Connecticut. However, as Dragor’s counsel concedes in its brief at p. 18, Footnote 9, Union never pursued this motion before the court below.



unique knowledge of Davis-Monthan Missile Launch construction problems, its unique knowledge of the Mosher Steel Company litigation, and the inevitable delay inherent in any renewal of the counterclaim controversy in an East Coast forum, all weighed conclusively in favor of retaining jurisdiction for the December 7 trial.<sup>9</sup>

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<sup>9</sup> Union, through counteraffidavit in opposition to Dragor's, stated:

"Since this Court heretofore set the compulsory counterclaim down for trial on December 7, 1965, both DRAGOR and UNION have expended substantial time and money in preparation for the trial of said claim. Extensive discovery, including the taking of depositions and the production of documents, has already been completed. UNION has been in the process of obtaining witnesses who it will bring on for trial, and the majority of said witnesses reside in the southwestern portion of the United States. The subject matter of the compulsory counterclaim further concerns, in one way or another, the manner in which work was done and conducted on the Titan II Missile Launch Facilities at the Davis-Monthan Air Force Base. This subject matter has been before this Court in one or another form for the past three years and no other court in the United States has the background, knowledge or experience with which to proceed to trial on the issues in said counterclaim.

"27. Said compulsory counterclaim further alleges that UNION breached the covenant not to sue given in conjunction with the October 3, 1963 settlement agreement by virtue of filing a counterclaim against Mosher Steel Company in the so-called *MOSHER STEEL COMPANY* litigation heretofore referred to. All matters and things pertaining to the *MOSHER STEEL COMPANY* litigation have been personally conducted before this Court and the effect of the covenant not to sue and the proceedings in the *MOSHER* case and any possible breach of covenant are all matters and things with respect to which this Court has unique knowledge.

"28. All of the assertions contained in the compulsory counterclaim pending before this Court alleges breaches of fiduciary duty in the prosecution of claims against the United States Government are in fact false and the discovery already taken in this proceeding establishes that such changes as were made by UNION in the assigned IMI-WARD joint venture claims were made because the claims as prepared and assigned by DRAGOR could not be substantiated or supported by records of the IMI-WARD joint venture and if filed in their original form would have subjected UNION and other persons working on said claims to possible prosecution under the False Claims Act of the United States.

"29. UNION is prepared and anxious to proceed with trial of DRAGOR'S compulsory counterclaim before this Court on December 7, 1965 and to secure an opportunity to prove that all of the charges of breach of covenant and deliberate and negligent mishandling of claims are false and without basis in fact and wholly without merit. The instant motion for voluntary discontinuation of this action, if granted, would prevent any adjudication of said compulsory counterclaim for an indefinite period of time and would cause the same to pend in the Connecticut forum where duplicative discovery and proceedings would have to be undertaken which would be wholly unnecessary before this Court." (R.2, pp. 201-3).

The court below, after full consideration of the merits of the motion, and after considering the affidavits of the parties and the arguments of their counsel, entered an order on November 10, 1965, denying Dragor's motion for voluntary dismissal of the counterclaim (R.2, p. 232).

On December 7, counsel for Union appeared, ready for trial, before the court below. No appearance was made by Dragor. The Court thereupon stated for the record (R.2, p. 205) :

“Let the record show that there is no appearance on behalf of the defendant and counterclaimant Dragor. Some ten days ago Mr. Hull called on me in chambers and advised me that he had been instructed that when this case was reached on this date he was not to make an appearance, he was not to present anything on the counter-claim, that the matter would be permitted to go by default. In view of that, I have not called a jury for this morning. But the plaintiff and counter-defendant announcing ready and the defendant and counterclaimant not appearing, I assume pursuant to the announced intention of abandoning the case, it is ordered that the counterclaim is dismissed for lack of prosecution.”

On the same date, judgment was entered by the Clerk of the court below, stating:

“This action came on regularly for trial this day before the Court, Honorable James A. Walsh, United States District Judge, presiding, and the defendant and counter-claimant having failed to appear for trial and the plaintiff and counter-defendant having appeared by counsel and having announced ready for trial,

“It is Ordered and Adjudged that the counterclaim herein is dismissed for failure of defendant and counterclaimant to prosecute the

same and that defendant and counterclaimant take nothing by virtue thereof.” (R.2, p. 207.)

The only question thus presented on this appeal is whether, in view of the above facts, the court below abused sound judicial discretion in dismissing Dragor’s counterclaim with prejudice pursuant to Rule 41(b) of the Federal Rules of Civil Procedure.



## ARGUMENT

### POINT I

**THE COURT BELOW HAD JURISDICTION OVER THE SUBJECT MATTER AND PARTIES TO DRAGOR'S COUNTERCLAIM. IN CONSEQUENCE, IT HAD JURISDICTION TO ENTER JUDGMENT DISMISSING THE COUNTERCLAIM FOR WANT OF PROSECUTION UPON DRAGOR'S DEFAULT.**

Dragor, in its opening brief, would create the impression that determination of the pending appeal is controlled on principles of *res judicata* by the prior decision of this Court with regard to the validity of the June 1, 1965 judgment. That decision determined only that the court below was without jurisdiction to enter a judgment against the defendant on the claims for relief alleged in plaintiff's complaint. The determination was made solely on the basis of the sufficiency of service of process. No question concerning the counterclaim, by which Dragor sought relief in the Court below, was raised or decided or presented on that record.

On the present appeal a completely separate and distinct question is presented which was not in any way determined by the prior adjudication of this Court. That question is whether the jurisdiction over the counterclaim of the court below was ancillary to plaintiff's suit on the note or was based on independent jurisdiction to entertain defendant's counterclaim praying for "a judgment against the plaintiff for a sum of not less than \$1,000,000" *without regard to the court's authority to entertain a claim for relief against Dragor on Union's complaint.*

When distinct questions are so placed in issue in different appeals on separate claims, principles of *res*



*judicata* are inapplicable. *Cromwell v. Sac County*, 94 U.S. 351, 356, 24 L. Ed. 195, 199 (1877) :

“It is not believed that there are any cases going to the extent that, because in the prior action a different question from that actually determined might have arisen and been litigated; therefore, such possible question is to be considered as excluded from consideration in a second action between the same parties on a different demand, although loose remarks looking in that direction may be found in some opinions. On principle, a point not in litigation in one action cannot be received as conclusively settled in any subsequent action upon a different cause, because it might have been determined in the first action.”

Because a question on this appeal is presented which is separate and distinct from that raised on prior review, this Court unquestionably has power to determine the present counterclaim jurisdiction dispute unfettered by any *res judicata* considerations. The question presented here has not yet been adjudicated.

**A. A Party Seeking Affirmative Relief Thereby Submits Himself to the Court's Jurisdiction.**

Consideration of the counterclaim jurisdiction question properly begins with the landmark decision in this field of law, which is *Merchants Heat & Light Company v. James B. Clow & Sons*, 27 S. Ct. 285, 204 U.S. 286, 51 L. Ed. 488 (1907).

Merchants, an Indiana corporation, was sued in an Illinois Federal Court through service of process on an alleged agent of the company. After its motion to quash the return of service was made and overruled, Merchants filed an answer pleading the general issue and also alleging a counterclaim for damages for breach of the same contract sued upon by plaintiff.

On appeal from a judgment for the plaintiff, Merchants again sought to raise the service of process question. This the Supreme Court refused to decide, holding that by voluntarily seeking affirmative relief through counterclaim, Merchants had submitted to the jurisdiction of the court. The Supreme Court, in an opinion by Mr. Justice Holmes, declared:

“We assume that the defendant lost no rights by pleading to the merits, as required, after saving its rights. *Harkness v. Hyde*, 98 U.S. 476, 25 L. Ed. 237; *Southern P. Co. v. Denton*, 146 U.S. 202, 36 L. Ed. 943, 13 Sup. Ct. Rep. 44. But by setting up its counterclaim the defendant became a plaintiff in its turn, invoked the jurisdiction of the court in the same action, and, by invoking, submitted to it.”

This conclusion was reached notwithstanding that the counterclaim arose, as it was said, “out of the same transaction that the plaintiff sued upon, and so to have been in recoupment rather than set-off proper.” Mr. Justice Holmes further said:

“There is some difference in the decisions as to when the defendant becomes so far an actor as to submit to the jurisdiction, but we are aware of none as to the proposition that when he does become an actor in a proper sense he submits.” The Supreme Court has never lost sight of the

*Merchants* principle, invoking the same to sustain jurisdiction over a defendant who had filed a cross-complaint against a third party (*Texas & P.R. Co. v. Eastin*, 29 S. Ct. 564, 214 U.S. 153, 53 L. Ed. 946 (1909)); to find a jury trial waiver by a defendant who filed a legal counterclaim to a bill in equity (*American Mills Co. v. American Surety Co.*, 43 S. Ct. 149, 260 U.S. 360, 67 L. Ed. 306 (1922)), and to find a waiver of an otherwise valid venue objection to an antitrust claim for relief (*Freeman v. Bee Ma-*

*chine Co.*, 63 S. Ct. 832, 319 U.S. 448, 87 L. Ed. 1509 (1943)).

Today, in consequence of *Merchants*, the general principle is established that a litigant who in any significant way invokes the jurisdiction of the federal court for the purpose of securing affirmative relief, thereby submits to the court's jurisdiction over the person. *North Branch Products, Inc. v. Fisher*, 284 F. 2d 611 (C.A. D.C., 1960); *Kincade v. Jeffery-DeWitt Insulator Corp.*, 242 F. 2d 328 (C.A.5, 1957); *Hadden v. Rumsey Products*, 196 F. 2d 92 (C.A.2, 1952); *Noerr Motor Freight v. Eastern R.R. Presidents Conference*, 155 F. Supp. 768, 838 (D.C. E.D. Pa., 1957); *Hook & Ackerman, Inc. v. Hirsch*, 98 F. Supp. 477 (D.C. D.C., 1951).

## **B. The "Compulsory" Counterclaim Issue.**

*Merchants* is determinative of the prior appeal from the June 1 judgment but for the claim now made that Dragor's counterclaim was compulsory. *Merchants* held that a defendant by voluntarily filing a counterclaim waived any personal jurisdiction defense to plaintiff's claim for relief. That Dragor's action in filing a counterclaim was voluntary is shown by the fact that it vigorously prosecuted it until it took DeBolt's deposition. It was only when it found it could not prevail that it sought voluntary dismissal. In 1A *Barron & Holtzoff, Federal Practice and Procedure*, § 370.2, p. 535, it is stated:

"Other decisions have held that the assertion of a counterclaim is a waiver today just as it would have been prior to the rules. The language of Rule 12(b), when carefully analyzed, does not seem to the contrary. The rule says, in relevant part: 'Every defense, in law or fact, to a claim for relief in any pleading, whether a claim, counterclaim, crossclaim, or third-party claim, shall



be asserted in the responsive pleading thereto \* \* \*. No defense or objection is waived by being joined with one or more other defenses or objections in a responsive pleading or motion.' It seems reasonably clear that in this passage the word 'counterclaim' refers back to 'claim for relief in any pleading,' rather than to 'defense,' and that a counterclaim is not a 'defense or objection' which may be asserted along with other defenses or objections without waiving them, within the purview of the later sentence of Rule 12(b). This is not to say that assertion of a counterclaim is such a waiver. The rules are simply silent on the question. A good argument could be made that finding a waiver in such circumstances is contrary to the general philosophy of the rules, but such an argument should be addressed to those who recommend amendments to the rules. Since the rules are silent the former doctrine, that there is such a waiver, must be held to have continued vitality."

To the same effect, see *Beaunit Mills, Inc. v. Industrias Reunidas F. Matarazzo*, 23 F.R.D. 654, 656 (S.D. N.Y., 1959).

Despite the absence of any express provision in the Federal Rules on this question, the Tenth Circuit has held that the filing of a compulsory counterclaim does not constitute a waiver of a personal jurisdiction defense *to a plaintiff's claim for relief*. *Hasse v. American Photograph Corporation*, 299 F. 2d 666 (C.A.10, 1962).

No suggestion, however, is contained in *Hasse*, or any other precedent, that preservation of a defendant's personal jurisdiction defense to a plaintiff's claim for relief compels the further conclusion that a court is without jurisdiction to entertain and dispose of a counterclaim where the Court has subject matter jurisdiction.



*Davis v. Ensign-Bickford Co.*, 139 F. 2d 624 (C.A.8, 1944) ; *Blank v. Bitker*, 135 F. 2d 962 (C.A.7, 1943) ; and *Sadler v. Penn. Refining Co.*, 33 F. Supp. 414 (W.D., S.C., 1944), all cited by Dragor in its brief at p. 23-24, do not involve the compulsory counterclaim issue, and are not in point.

On the contrary, so far as diligent research reveals, every United States Court of Appeals considering the question has held that a District Court, although found to be without jurisdiction to grant relief on plaintiff's complaint, may yet retain and adjudicate any counterclaim, compulsory or otherwise, provided such counterclaim is within the subject matter jurisdiction of the court.

### **C. Authorities Confirming Judge Walsh's Counterclaim Jurisdiction.**

One of the first cases deciding this question was the Second Circuit's decision in *Vidal v. South American Securities Co.*, 276 Fed. 855 (C.A.2, 1922). Vidal, an alien, brought a suit in equity in the New York District Court against Bright, Securities Company, Railway Company, Construction Company, and others, to fix and determine plaintiff's rights to securities in accordance with the contract between one or more of the parties. Jurisdiction was invoked pursuant to the then Section 57 of the Judicial Code, which permitted service by publication in any suit to enforce a legal or equitable claim to personal property within the judicial district. The defendants unsuccessfully contested jurisdiction by motion, whereupon each of the defendants, except Bright, sought affirmative relief by counterclaim or cross-claim. The District Court, at the conclusion of the case, entered a decree granting plaintiff's prayer for relief, granting the prayers contained in the cross-complaints of

Railway Company and Construction Company, and dismissing Securities Company's counterclaim on the merits.

On appeal, the Second Circuit held that the securities in suit did not constitute personal property within the judicial district within the meaning of Section 57. Since Bright, an indispensable party, resided abroad and could in no event be served in any other manner, the District Court's decree was reversed and remanded, with directions to dismiss the proceedings below.

A petition for rehearing was thereupon filed, pointing out that irrespective of the court's jurisdiction to grant relief on the complaint, independent jurisdiction existed with respect to the claims of defendants seeking affirmative relief by cross-claim and counterclaim. The court granted rehearing, and thereupon filed a further opinion, declaring, at p. 874:

"We dismissed the original bill in this case because the plaintiff had no lien upon or claim to the securities mentioned under section 57 of the Judicial Code, and also because the defendant Bright was not an inhabitant of the Southern district of New York or served therein. Following the general rule that a cross-bill falls with the original bill, we also dismissed the counterclaims which under equity rules 30 (201 Fed. v, 118 C.C.A. v) and 31 (198 Fed. xxvii, 115 C.C.A. xxvii), are substituted for cross bills. . . .

"As the counterclaims set up causes of action within the jurisdiction of the court as a court of equity, and within its jurisdiction as a federal court because of the citizenship of the parties, except in the case of the defendant Bright [who sought no affirmative relief], they should not have been dismissed, but should have been treated as original bills upon the dismissal of the original bill."



The Second Circuit thereupon remanded the case, directing that affirmative relief on their counterclaims be given Railroad Company and Construction Company.

Another case to the same effect decided by this Court is that of *Pioche Mines Consol. v. Fidelity-Philadelphia Trust Co.*, 202 F. 2d 944 (C.A.9, 1952), further opinion 206 F. 2d 336 (C.A.9, 1953). There, Fidelity, by supplemental complaint, sought a decree to enforce an agreement settling prior litigation involving Consolidated's default in paying debenture obligations. Consolidated first attempted to dismiss the supplemental complaint for want of an indispensable party defendant who was not amenable to service of process. Consolidated also filed a \$3,000,000 counterclaim alleging that Fidelity and others had conspired to prevent consummation of the settlement for the purpose of financially crippling Consolidated. Following a summary judgment hearing, the trial court granted plaintiff a decree and dismissed the counterclaim.

On appeal, this Court upheld Consolidated's indispensable party objection and reversed the court below, with directions to dismiss. Consolidated thereupon petitioned for rehearing on the ground that the District Court's inability to secure jurisdiction over the parties necessary to adjudicate the complaint, did not destroy its independent jurisdiction to adjudicate the counterclaim. Consolidated, in consequence, argued that it was entitled to have this Court determine whether the District Court's dismissal of the counterclaim on summary judgment was correct.

This Court, just as in *Vidal*, granted the petition for rehearing and ordered the judgment dismissing the counterclaim reversed, with leave to Consolidated

to amend. In its further opinion, the court declared (206 F. 2d, at p. 336) :

“We heretofore ordered the dismissal of the supplemental complaint of appellee Fidelity in this case for absence of indispensable parties. *Pioche Mines Consolidated v. Fidelity-Philadelphia Trust Co.*, 202 F. 2d 944. In ruling on the case we neglected the issue whether the trial court’s dismissal of Pioche’s counterclaim was proper. Pioche petitioned for a rehearing requesting that we pass on that matter. Fidelity was asked to present a brief expressing its views on the subject and has done so. To this Pioche has replied, and the neglected issue is now before us for disposition.

“Fidelity argues that the dismissal of its complaint renders mandatory a dismissal of the counterclaim also. We think not. *Compulsory counterclaims are required to be dismissed only when the complaint is dismissed for want of jurisdiction, which was not the case here. The counterclaim persists where it is supported by an independent ground of federal jurisdiction, Isenberg v. Biddle*, 75 U.S. App. D.C. 100, 125 F. 2d 741; 3 *Moore’s Federal Practice* § 13.15. Pioche is a resident of Nevada, Fidelity of Pennsylvania; and federal jurisdiction thus rests on diversity.” (Emphasis added.)

In stating, “Compulsory counterclaims are required to be dismissed only when the complaint is dismissed for want of jurisdiction,” this court was apparently referring to the fact that such counterclaims, unlike permissive counterclaims, are deemed ancillary to the main action and ordinarily *need* no independent jurisdiction grounds to support them. *New York Life Insurance Co. v. Kauffman*, 78 F. 2d 398 (C.A.9, 1935), cert. den. 296 U.S. 626, 80 L. Ed. 445 (1935); 3 *Moore’s Federal Practice* (2d Ed.), ¶ 13.15 at p. 41. When a court has *only* ancillary jurisdiction of a compulsory counterclaim, that counter-



claim, of course, must be dismissed if jurisdiction over the complaint is lacking. But irrespective of jurisdiction over the complaint, a counterclaim persists, as this Court further stated, “when it is supported by independent grounds of federal jurisdiction.”

The Seventh Circuit so construed this Court’s *Pioche* opinion in *Switzer Bros., Inc. v. Chicago Cardboard Co.*, 252 F. 2d 407 (C.A.7, 1958). There, on appeal, plaintiff contended that by reason of a finding of the trial court that it had no jurisdiction to entertain a patent infringement complaint, the trial court necessarily lost jurisdiction to proceed with a counterclaim which stated a separate cause of action based upon the antitrust laws. The Seventh Circuit rejected this contention and, in addressing itself to the *Pioche* case, declared, at p. 410:

“It is true that in the *Pioche* case the court held that dismissal of a complaint for want of jurisdiction also requires dismissal of a compulsory counterclaim. However, the court at the same time stated (206 F. 2d, at page 366):

“ ‘The counterclaim persists where it is supported by an independent ground of federal jurisdiction . . .’ ”

The Seventh Circuit went on to hold, at p. 410:

“It appears to be settled that where a counterclaim states a cause of action seeking affirmative relief independent of that stated in the complaint, the dismissal of the complaint does not preclude a trial and determination of the issues presented by the counterclaim. *Lyon Mfg. Corp. v. Chicago Flexible Shaft Co.*, 7 Cir., 106 F. 2d 930, 933; *Haberman v. Equitable Life Assurance Society of the United States*, 5 Cir., 224 F. 2d 401, 409.

“It is our conclusion that plaintiff’s contention is not sound. It is true, of course, that a Court in an action for patent infringement is

without jurisdiction to proceed in the matter in the absence of indispensable parties, which includes all of the owners of the patent. *Independent Wireless Telegraph Co. v. Radio Corp. of America*, 269 U.S. 459, 468, 46 S. Ct. 166, 70 L. Ed. 357. Thus, the Court was justified in dismissing the complaint and paragraph 18 of plaintiff's counterclaim for the lack of indispensable parties as plaintiffs. It does not follow, however, that the Court at the same time lost jurisdiction to entertain the counterclaims. It is not open to question but that the Court under Title 28 U.S. C.A. § 1338 acquired jurisdiction of the subject matter of the original action. The Court also acquired jurisdiction of the subject matter of Radiant's counterclaim by reason of Title 15 U.S.-C.A. § 15, which provides that suit may be brought for a violation of the antitrust laws 'in any district court of the United States in the district in which the defendant resides or is found.' "

Both this Court in *Pioche*, and the Seventh Circuit Court of Appeals in *Switzer*, cited in support of its conclusion the decision in *Isenberg v. Biddle*, 125 F. 2d 741 (C.A. D.C., 1941). Plaintiff there brought suit to recover the value of property allegedly seized while plaintiff was wrongfully accused of being an enemy alien. The United States denied the allegations and counterclaimed to recover back sums already paid the plaintiff. The District Court determined that the plaintiff had in fact been an enemy alien and, accordingly, dismissed the complaint for want of jurisdiction. At the same time, the court granted the Government a money judgment on its counterclaim.

On appeal, the court held that the failure of jurisdiction over the complaint did not bar an adjudication of the counterclaim. Chief Judge Grover, speaking for the court, stated, at p. 743:

"As to the first, counsel insists that when the bill of complaint was dismissed, 'the keystone of



the District Court's jurisdiction fell and the counterclaim should have been dismissed with the bill.' *Moore v. New York Cotton Exch.*, 270 U.S. 593, 607-609, 46 S. Ct. 376, 70 L. Ed. 750, 45 A.L.R. 1370, and *Kelleam et al v. Maryland Casualty Co.*, 312 U.S. 377, 61 S. Ct. 595, 85 L. Ed. 899 are cited to sustain this position. In the last named case, Justice Douglas, speaking to the facts in that case, said that once the bill of complaint was dismissed no jurisdiction remained for any grant of relief under the cross petition. *But in that case there was no jurisdictional basis for the counterclaim independent of the main action.* In the *Moore* case the dismissal of the main bill was not for want of jurisdiction, and the court refused to dismiss the counterclaim. Though it is suggested by Professor Shulman that it is implicit in the case that, if a plaintiff's action is dismissed for want of jurisdiction, the counterclaim falls, he adds that this is so only if there is no independent jurisdictional basis for the counterclaim. 45 Yale L.J. 393, 413. Here there is such independent basis, and the rule is that in such circumstances, when the counterclaim seeks affirmative relief, it is sustainable without regard to what happens to the original complaint." (Emphasis supplied.)

*Pioche, Switzer and Isenberg* were also relied upon by Judge Maris in his opinion in *Sachs v. Sachs*, 265 F. 2d 31 (C.A.3, 1959). There, on an appeal from the District Court of the Virgin Islands, the Third Circuit held that a complaint for divorce had been properly dismissed because the complainant was found to be a resident of Massachusetts. At the same time it held that the court had independent jurisdiction to entertain the defendant's counterclaim seeking a judgment for arrearages in support money due under a prior Massachusetts decree. Judge Maris declared, at 265 F. 2d 33:

"The counterclaim was an independent claim against the plaintiff based upon the judgment

of the Massachusetts probate court. If supported by independent grounds of jurisdiction, the district court could entertain it regardless of that court's lack of jurisdiction over the complaint. *Isenberg v. Biddle*, 1941, 75 U.S. App. D.C. 100, 125 F. 2d 741, 743; *Pioche Mines Consol. Inc. v. Fidelity-Philadelphia Trust Co.*, 9 Cir. 1953, 206 F. 2d 336, certiorari denied 346 U.S. 899, 74 S. Ct. 225, 98 L. Ed. 400; *Haberman v. Equitable Life Assurance Society of the United States*, 5 Cir. 1955, 224 F. 2d 401, 409, certiorari denied 350 U.S. 948, 76 S. Ct. 322, 100 L. Ed. 826; *Switzer Brothers, Inc. v. Chicago Cardboard Co.*, 7 Cir. 1958, 252 F. 2d 407, 410; 3 *Moore's Federal Practice*, 2d Ed., § 13.15. For there is no question but that section 22 of the Revised Organic Act, 48 U.S.C.A. § 1612, gives the district court subject matter jurisdiction over actions brought to enforce judgments for support. Thus such actions, whether original or interposed by way of counterclaim, may be entertained so long as the court has jurisdiction over the defendant in person or over his property. (Citations.) And here the plaintiff, having submitted himself to the jurisdiction of the district court by filing his complaint and appearing therein, put it within the power of the court to render a personal judgment against him on the counterclaim. *Adam v. Saenger*, 1938, 303 U.S. 59, 58 S. Ct. 454, 82 L. Ed. 649. We conclude that the district court did not err in entertaining the defendant's counterclaim and granting the defendant judgment thereon."

For identical District Court precedent in this Circuit see *Elliott v. Federal Home Loan Bank Board*, 233 F. Supp. 578 (S.D. Cal. 1964) (opinion by Hall, D.J.); *Pierce v. Perlites Aggregates*, 110 F. Supp. 684 (N.D. Cal., 1952) (opinion by Lemmon, D.J.). Compare *In Re Snow Camp Logging Company*, 168 F. Supp. 420 (N.D. Cal., 1958) (opinion by Halbert, D.J.).

The Rules of Civil Procedure, in express terms,



demonstrate that the counterclaim is independent of plaintiff's suit on the promissory note.

Thus, Rule 13(i) provides:

“SEPARATE TRIALS; SEPARATE JUDGMENTS. If the court orders separate trials as provided in Rule 42(b), judgment on a counterclaim or cross-claim may be rendered in accordance with the terms of Rule 54(b) *when the court has jurisdiction so to do*, even if the claims of the opposing party have been dismissed or otherwise disposed of.” (Emphasis added.)

**D. Defendant's Authorities Further Confirm Judge Walsh's Jurisdiction.**

Doubtless this Court will have noticed that none of the foregoing authorities, despite their evident pertinency, were considered in Dragor's brief. The only comparable precedents mentioned by Dragor are *Haberman v. Equitable Life Assurance Society of the United States*, 224 F. 2d 401 (C.A. 5, 1955) (Dragor Brief p. 17, Footnote 7), and *Manufacturers Cas. Ins. Co. v. Arapahoe Drilling Co.*, 267 F. 2d 5 (C.A.10, 1959) (Dragor's Brief p. 27).<sup>10</sup>

In the *Haberman* case, Equitable brought suit for a declaratory judgment determining its liability, if any, under an annuity policy. Defendant Haberman, as executor, answered and also counterclaimed for amounts allegedly due under the same policy. Following trial, the District Court granted the requested declaratory judgment relief, and also found that defendant was entitled to no further amounts under the policy.

On appeal, the Fifth Circuit *sua sponte* raised the issue whether defendant could avoid the adverse

<sup>10</sup> *Kelleam vs. Maryland Casualty Company of Baltimore*, 312 U.S. 377 (85L Ed. 899, 1941) (cited in Dragor's Brief pp. 26-7) is considered and distinguished in the quoted passage of Judge Grover's opinion in *Isenberg*, *supra*, p. 30).

adjudication on the ground that Equitable did not have capacity to sue. Under the Texas statute, Equitable, as a condition to doing business, was required and had failed to designate a Texas resident for receiving service of process. The pertinent Texas statutory provision declared that a corporation failing to comply with the statute was barred from prosecuting suits in the Texas courts.

The court concluded, however, that any incapacity to prosecute a declaratory judgment claim did not extend to defending a counterclaim. Inasmuch as the court had independent jurisdiction of the counterclaim, the judgment adjudicating the merits was affirmed, Judge Tuttle stating (p. 409):

“Although he has not thus far raised the issue, appellant may object that, granted our assumption that Art. 2031a applies to a foreign insurance company, the court has no jurisdiction of the action because § 5(b) of that Article incapacitates Equitable from bringing any action. However, this objection has no merit even under the assumption made. Such a statute disabling a foreign corporation from bringing an action does not disable it from defending an action, *Home Forum Ben. Order v. Jones*, 20 Tex. Civ. App. 68, 48 S.W. 219; 23 Am. Jur. ‘Foreign Corporations’ § 335; Annotation, 17 L.R.A., N.S., 1117; consequently Equitable could defend the counterclaim in the present action. That counterclaim was a compulsory counterclaim under Rule 13(a), Federal Rules of Civil Procedure, and even if the complaint be dismissed, a compulsory counterclaim is not required to be dismissed where it is supported by a proper ground of federal jurisdiction. *Pioche Mines Consol., Inc. v. Fidelity-Philadelphia Trust Co.*, 9 Cir., 206 F. 2d 336, certiorari denied 346 U.S. 899, 74 S. Ct. 225, 98 L. Ed. 400; *Isenberg v. Biddle*, 75 U.S. App. D.C. 100, 125 F. 2d 741; 3 *Moore’s Federal Practice* § 13.15. Here, federal jurisdiction of the counter-



claim is present because there was diversity of citizenship and the requisite amount in controversy. Consequently, whether or not *Equitable* had the capacity to bring this action, this court has and the court below had, jurisdiction, *Haberman* having allowed the action and counterclaim to go to final judgment on the merits.”

*Haberman*, like the authorities heretofore considered, confirms the conclusion that the court below retained independent jurisdiction to adjudicate *Dragor*’s counterclaim. *Dragor*, nevertheless purports to distinguish its counterclaim situation on the ground that unlike *Haberman*, *Dragor* defaulted and did not allow the “counterclaim to go to final judgment on the merits” by participating in a trial of its claim. (*Dragor* Brief p. 17, Footnote 7.)

This attempted distinction of *Haberman* is without substance because the precedents already considered demonstrate that authority to adjudicate an independent counterclaim does not depend upon whether at the time of appeal the same has been disposed of by trial or default, or simply remains pending for further proceedings. In *Switzer*, for example, the District Court had entered a Rule 54(b) judgment dismissing the patent infringement complaint but retaining the antitrust counterclaim for a separate and future trial—a situation comparable to that presented by *Dragor*’s present appeal. In holding that the District Court retained independent jurisdiction of the counterclaim, the Seventh Circuit patently concluded that such jurisdiction did not depend upon whether or not the counterclaim was still pending.

*Arapahoe*, the second precedent discussed by *Dragor*, is described as involving a “set of facts substantially resembling those of the instant case.” (*Dragor*’s Brief p. 27.) The facts actually were that *Manufacturers* had entered the case as an intervenor

plaintiff by reason of subrogation rights arising through payment of compensation to the original plaintiff, Campbell. Defendant Arapahoe counterclaimed against Manufacturers, contending that the former was an additional insured under a policy issued by Arapahoe to plaintiff's employer. Arapahoe's counterclaim sought judgment over against Manufacturers in the event Arapahoe was held liable to Campbell.

It was then discovered that no diversity of citizenship existed between Campbell and Arapahoe. The District Court thereupon dismissed the main case and vacated an order previously entered adjudicating the counterclaim issues against Arapahoe.

On appeal, the Tenth Circuit reviewed the authorities considered in this brief, declaring, at p. 7:

“And indeed it seems well settled that where a jurisdictional basis exists for a counterclaim it may sometimes be considered, though the complaint fail for want of jurisdiction.”

In order for such a counterclaim to remain for consideration, Judge Lewis went on to declare that three conditions must exist, namely:

“Jurisdiction must exist within the scope of the allegations of the counterclaim; the claim made in the counterclaim must be independent of that made in the main case; and, lastly, affirmative relief must be sought.”

Judge Lewis concluded that the second condition, independent status, did not exist because Arapahoe's counterclaim asserted a claim over *only in the event the counterclaimant were held liable to the plaintiff*. Dismissal of the plaintiff's complaint made the counterclaim meaningless. Judge Lewis stated:

“So completely was the specific counterclaim related in practical effect to the outcome



of plaintiff Campbell's cause of action *that it became meaningless upon dismissal of the complaint.*" (Emphasis added.)

It should be noted that under Judge Lewis' test, Dragor's counterclaim clearly meets the three prescribed conditions. Condition 1, subject matter jurisdiction, exists by virtue of diversity of citizenship and jurisdictional amount; condition 2, independent status, exists because Dragor's breach of contract allegations with respect to prosecution of claims for equitable adjustment, and with respect to the Mosher litigation, constitute causes of action irrespective of Union's \$1,000,000 note indebtedness claim; condition 3, affirmative relief, exists because Dragor seeks "an affirmative judgment for not less than \$1,000,000" which is allegedly due irrespective of the merits of Union's claim.

We submit that the foregoing authorities here reviewed should dispel any doubts this Court might have concerning Judge Walsh's jurisdiction to entertain Dragor's counterclaim. That jurisdiction, we respectfully submit, is unimpeachable.

## POINT II

**THE COURT BELOW DID NOT ABUSE ITS DISCRETION IN REFUSING TO GRANT LEAVE TO DRAGOR TO DISCONTINUE ITS COUNTERCLAIM WITHOUT PREJUDICE.**

Dragor's second specification of error is that the District Court erred in denying Dragor's motion for leave to discontinue its counterclaim without prejudice pursuant to Rule 41(a)(2) of the Federal Rules of Civil Procedure. This specification is without merit.

**A. Whether Voluntary Dismissal Will Be Granted Is a Matter of Sound Judicial Discretion.**

Rule 41(a)(2) of the Federal Rules of Civil Procedure states in pertinent part:

“(2) *By Order Of Court.* Except as provided in paragraph (1) of this subdivision of this Rule, an action shall not be dismissed at the plaintiff's instance save upon order of the court and upon such terms and conditions as the court deems proper.”

The language of the above Rule by its terms establishes that Dragor was not entitled to voluntary dismissal as a matter of right. Rather, the District Court was called upon to exercise its sound judicial discretion and judgment in order to determine whether dismissal was in the interests of justice under the facts of this case. As Judge Carswell stated, in *American Cyanamid Co. v. McGhee*, 317 F. 2d 295, 298 (C.A.5, 1963):

“[Under Rule 41(a)(2) the District] Court has an express judicial function to perform. All of the concepts and process of judicial determination are brought into play. The merits of each motion must be considered and a ruling made by the court. There is no language under this sec-

tion which pre-ordains the ultimate judicial decision on a motion made under its terms . . . Rather than restricting a judicial function, as is done under 41(a)(1), dismissals by the court on motion under 41(a)(2) plainly puts upon the court a definite duty to perform: to grant or deny the motion, and to establish 'such terms and conditions as the court deems proper.' ”

This Circuit has similarly concluded that voluntary dismissal under Rule 41(a)(2) is not a matter of right, but involves exercise of judicial discretion. In *Blue Mountain Construction Company v. Werner*, 270 F. 2d 305 (C.A.9, 1959), this Court was called upon to pass upon the propriety of Judge Solomon's denial of a motion to dismiss where the complaining party was “squarely representing to the trial court that their purpose in requesting a dismissal in the Oregon District was to enable them to institute an action in the Eastern District of Washington.” In upholding the denial of the motion to dismiss, this Court clearly recognized the discretionary character of the District Court's judicial function in ruling upon such a motion. Judge Orr, speaking for the Court, stated at page 306:

“Whether or not a dismissal will be granted is within the sound judicial discretion of the Court. *Ockert v. Union Barge Line Corp.*, 3 Cir., 1951, 190 F. 2d 303; *Rollison v. Washington National Ins. Co.*, 4 Cir., 1949, 176 F. 2d 364. We think it follows that each case must be determined on its own particular facts. We find no abuse of discretion in the denial of this motion.”

This Court, in *Blue Mountain*, declared further that a party who refused to proceed with his claim upon denial of a Rule 41(b)(2) motion did so at his own risk. If no abuse of discretion existed in denying the motion, the party thereafter could not refuse to proceed and yet complain of a subsequent dismissal



with prejudice for want of prosecution. Judge Orr stated, at p. 307:

“After the denial of their motion to dismiss, appellant informed the court that they refused to proceed further. Appellant took this position at its peril. If the trial court was in error in refusing to dismiss without prejudice, appellant was on safe ground, but on the other hand, as we find there was no abuse of discretion, then the subsequent action of the court in dismissing the action with prejudice for want of prosecution was proper.

“The trial court set the case for pre-trial conference on July 21, 1958. The matter came on for pre-trial conference on said date. No appearance was made for or on behalf of appellant. In view of the information given the court that appellant would not proceed further, it justifiably concluded that there was a failure to prosecute and dismissed the action with prejudice under Rule 17 of the Oregon District Court and Rule (41(b) F.R. Civ. P.

Indeed, Judge Fee believed Blue Mountain’s positive defiance of the trial court in refusing, after denial of its voluntary dismissal motion, to again appear before the trial court or to participate in a scheduled pre-trial conference of itself constituted grounds for dismissal with prejudice. Judge Fee, in his concurring opinion, stated at p. 308:

“Irrespective of the question of abuse of discretion, the trial court had a right to dismiss the cause under this Rule because of the positive defiance of the order of the court setting the case for pre-trial conference . . .

“The judgment of dismissal should be affirmed.”

*Blue Mountain*, for the very considerations suggested by Judge Orr and Judge Fee, clearly establishes the propriety of Judge Walsh’s action in this case.



**B. Denial of Dragor's Motion to Discontinue Constituted No Abuse of Discretion.**

The record facts, we believe, establish conclusively that Judge Walsh's action in denying Dragor's motion, not only did not constitute an abuse of his discretionary authority but such ruling was the only result consistent with considerations of justice and fair play. As we have pointed out, Dragor's counterclaim in this action has from the beginning constituted Dragor's only ostensible ground or excuse for refusing to pay the \$1,000,000 note indebtedness which was undeniably due on September 30, 1964. For six months in the proceedings below Dragor consistently demanded an opportunity to try its counterclaim. On that ground, it opposed Union's motion for judgment on the pleadings and request for Rule 54(b) certification; it sought a stay of enforcement of Union's judgment, and pressed discovery for the sake of an early trial. Only after discovery was completed, and Dragor had an opportunity to explore the lack of merit in its unfounded assertions did it seek to postpone and avoid an adjudication. Only at this point did Dragor belatedly raise an objection to the court's jurisdiction over the counterclaim.

Union, convinced that the counterclaim allegations were false and meritless, welcomed Dragor's demand for an early trial date. The pendency of the counterclaim as an excuse for non-payment of Dragor's note indebtedness, and the complications it created in negotiations with the United States Government on claims for equitable adjustment made an early adjudication of the counterclaim of paramount importance to Union. On the other hand, the value of the counterclaim to Dragor, as an excuse for non-payment, necessarily depended upon postponing its adjudication as long as possible in order to deny the

plaintiff an opportunity of proving the same to be totally without merit.

Recognizing these considerations, Dragor, on October 25, 1965, six weeks before the December 7 trial date set on the preceding July 7, sought to avoid the trial by a discontinuance. Dragor pretended that it wanted Judge Zampano, in Connecticut, to assume the burden of trying out the host of complex issues concerning the performance of construction work on the 18 Titan II Missile bases at Tucson, the manner in which construction problems gave rise to claims for equitable adjustment, and the way in which these claims were presented to Col. Hoover, the government Contracting Officer in Tucson, and to the Board of Contract Appeals.

Dragor further alleged that it wanted Judge Zampano to review the proceedings in the *Mosher* case tried by Judge Walsh (and now on appeal to this Court), in order to determine whether Union's conduct in that proceeding constituted a violation of any of the terms of the October 3, 1963 settlement agreement. In other words, Judge Zampano was being asked to review a matter of which Judge Walsh had personal knowledge. It is no wonder, then, that Judge Zampano did not want to entertain such proceedings in his Court and finally stayed all proceedings in Connecticut in order to permit a full and complete disposition of the controversy in the Arizona forum.

Despite Judge Zampano's obvious willingness to have the entire counterclaim controversy disposed of in Arizona, Dragor nevertheless argued that it should be permitted to prosecute its counterclaim in Connecticut because Isbrandtsen was a party to that action and had entered no appearance in the Arizona proceedings. Dragor neglects to mention, however, that Isbrandtsen's presence in Connecticut was irrelevant



to the counterclaim controversy. The proof of this is established by the fact that Dragor, in its third party claim against Union, did not join and never attempted to join Isbrandtsen as a party. Isbrandtsen's presence in the Connecticut action therefore would not aid a determination of the controversy between Union and Dragor. He was a mere guarantor, or surety, and as such could not avail himself of a claim of Dragor against Union. *United States v. Berger*, 24 F.R.D. 136 (D.C. Cal., 1959); *Construction Management Corporation v. Brown & Root, Inc.*, 229 N.Y.S. 2d 70 (1962).

Dragor also urged that Judge Zampano should assume the counterclaim litigation in order to relieve Dragor of the burden and costs of two litigations instead of one. The fact of the matter, however, was that Dragor became involved in litigation with Union in Connecticut only by virtue of its filing its Arizona counterclaim as a permissive third party claim. It alone created the situation where litigation existed in two forums; it then sought to assert as grounds for discontinuing the Arizona counterclaim its conduct in creating concurrent and vexatious litigation in Connecticut.

As a final consideration, it should be remembered that all of this Missile Base construction contract litigation was brought to this forum by Dragor. Union's original action to recover the amounts expended in completing the joint venture's work was initially filed in the United States District Court for the Northern District of Illinois, Eastern Division. It was Dragor who appeared in that action and secured a transfer of the case pursuant to 28 U.S.C. Section 1404(a) to the Arizona District Court. When then seeking a transfer of the same controversy to Arizona, Dragor's president, by affidavit, stated in part as follows:

"It is clear that Illinois has no connection

with this litigation. The project, and witnesses, and the documents are in Arizona . . . This court does not have and cannot obtain jurisdiction over IMI, without which there will be mere circuitry of litigation. In this action all three parties are subject to the jurisdiction of the Arizona District Court in Tucson, Arizona, or the California District Court, Southern District of California, Central Division.

“It is clear from the foregoing that the interest of justice would certainly best be served by a transfer of this action to the State of the project, to-wit: the appropriate United States District Court in Tucson, Arizona . . .

“Plaintiff is authorized to do business and has an agent for the receipt of process in both Arizona and California, and so does the defendant. Thus it is clear that all three parties would be before the court in either Arizona or California with the attendant facility of trial, from a trial facility point of view, heavily weighted in favor of Arizona.”

Just as in the construction controversy in the original action filed by Union in Illinois and transferred to Arizona at Dragor's request, the counterclaim here concerns claims for equitable adjustment against the United States arising out of work performed in Tucson, Arizona and the prosecution of such claims before the Corps of Engineers. This fact makes the District Court in Tucson, Arizona the appropriate forum for resolving this controversy. The same type of problems concerning the manner of construction, the time scheduling, change orders on the project, impact and acceleration problems, joint occupancy problems, all are present in the counterclaim controversy just as in the original action. Therefore, for the very grounds stated by Dragor in the affidavit of its president made at the inception of all these proceedings, the counterclaim controversy should be tried



in Arizona. Indeed, trial in an East Coast forum would be so burdensome, in terms of transferring documents and producing witnesses having knowledge of the project problems, as to justify a transfer from Connecticut to Arizona in the interests of justice, pursuant to 28 U.S.C. Section 1404(a).

## CONCLUSION

For each of the foregoing reasons, appellant Union Tank Car Company respectfully prays that this Court affirm the judgment of the United States District Court for the District of Arizona, sitting at Tucson, entered on December 7, 1965, dismissing for want of prosecution Dragor's counterclaim against appellee.

Respectfully submitted,  
Harold C. Warnock  
Thomas C. McConnell

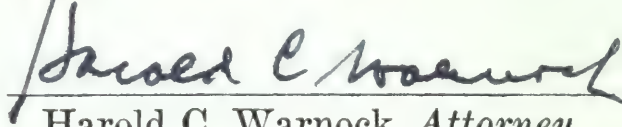
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**CERTIFICATE OF COMPLIANCE**

I certify that, in connection with the preparation of this brief, I have examined Rules 18 and 19 of the United States Court of Appeals for the Ninth Circuit, and that, in my opinion, the foregoing brief is in full compliance with those rules.

  
Harold C. Warnock, *Attorney*

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**United States Court of Appeals**

FOR THE NINTH CIRCUIT

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DRAGOR SHIPPING CORPORATION, a corporation, formerly  
WARD INDUSTRIES CORPORATION,

*Appellant,*

vs.

UNION TANK CAR COMPANY, a corporation,

*Appellee.*

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ON APPEAL FROM THE DISTRICT COURT OF THE UNITED STATES  
FOR THE DISTRICT OF ARIZONA

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**REPLY BRIEF OF APPELLANT,  
DRAGOR SHIPPING CORPORATION**

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No. 20904

# United States Court of Appeals

FOR THE NINTH CIRCUIT

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DRAGOR SHIPPING CORPORATION, a corporation, formerly  
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*Appellant,*

vs.

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*Appellee.*

---

ON APPEAL FROM THE DISTRICT COURT OF THE UNITED STATES  
FOR THE DISTRICT OF ARIZONA

---

## REPLY BRIEF OF APPELLANT, DRAGOR SHIPPING CORPORATION

---

### The Position of Union Upon This Appeal

The brief filed by Union upon this appeal is founded entirely upon its total repudiation of the solemn representations of fact and law with which it had urged this Court, in March of 1965, to deny Dragor's application for a writ of prohibition for the purpose of reviewing, before Dragor was forced to file a compulsory counterclaim, the Arizona District Court's unconstitutional assumption of jurisdiction over the person of Dragor in this action.<sup>1</sup>

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<sup>1</sup> On April 7, 1966, this Court unanimously held that the Arizona District Court never acquired any jurisdiction over the person of Dragor in this case (361 Fed (2d) 43). On October 10, 1966, the United States Supreme Court denied Union's application for a writ of certiorari to review that decision.



At that time, this Court was assured by Union, in the most absolute of terms, that the apprehension voiced by Dragor in its application for this Court's interlocutory review was wholly unfounded; that "the authorities hold *without exception* that the pleading of a compulsory, as distinguished from a permissive, counterclaim constitutes no waiver of a previously asserted jurisdictional defense"; and that the waiver which might result from the filing of a *permissive* counterclaim which a defendant voluntarily elects to assert could not possibly apply to Dragor's *compulsory* counterclaim in this case, "since defendant has no choice but is *coerced* into asserting his claim as a counterclaim" (Union Statement of Points and Authorities, pp. 21-24).<sup>2</sup>

Having advised this Court at that time that the issue is one "with respect to which there is no conflict of authority" and having thereby succeeded in forcing Dragor to interpose its compulsory counterclaim, Union now blandly informs this Court, in a complete volte-face, that "Dragor's action in filing a counterclaim was voluntary" and that it thereby voluntarily "submitted" to the *in personam* jurisdiction of the Arizona District Court (Union Brief, p. 22).

In seeking this Court's approval of its proposed entrapment of Dragor and the destruction of its constitutional rights, Union has distorted the record, misstated the cases, and attempted to obliterate the distinction between compulsory and permissive counterclaims effected by Rule 13 of the Federal Rules of Civil Procedure. In addition, it presents a new theory of a divisible and fragmentary *in personam* jurisdiction which has never before been voiced.

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<sup>2</sup> Union's Statement of Points and Authorities submitted in opposition to Dragor's application for a writ of prohibition in this Court will hereafter be designated as Union Statement.

let alone supported, by any competent constitutional authority.

We now turn to a critical analysis of the arguments which Union offers in its brief upon this appeal to sustain the precise opposite of the factual and legal position which it had induced this Court to accept in March of 1965.

### POINT I

**Union is judicially estopped to repudiate its prior representations to this Court, upon Dragor's application for a writ of prohibition, that the involuntary filing of a compulsory counterclaim would not constitute a submission to the previously challenged jurisdiction of the Arizona District Court over the person of Dragor.**

In our opening brief (pp. 7-12), we described Dragor's unremitting and unsuccessful efforts to procure this Court's review of the erroneous decision by the Arizona District Court denying Dragor's motion to quash the service of process herein before Dragor was required, under the Federal Rules of Civil Procedure, to file its answer to the plaintiff's complaint. We emphasized the apprehension which Dragor repeatedly expressed, both in this Court and the Court below, that the pleading of a compulsory counterclaim, though involuntary and coerced, *might* be deemed a waiver of its previously asserted objections to the *in personam* jurisdiction of the District Court.

In the District Court, Dragor had expressed that concern as follows (R. 1, pp. 89-90):

"Under Rule 13(a), Ward will be compelled, if the action continues in this Court, to file its counterclaim as a compulsory counterclaim. If it does not do so, that counterclaim may be deemed forever waived. If such a counterclaim is filed, I am advised by counsel

that the interposition therof, even though it be a compulsory counterclaim, may automatically constitute a waiver of any objections to the jurisdiction of this Court over the person of the defendant which may be set forth in the answer or which may have been taken previously by motion.”

Upon its application to this Court for a writ of prohibition, Dragor had reiterated its concern in the following language (Dragor’s Statement of Points and Authorities, pp. 11-12):<sup>3</sup>

“Under the decisions of federal courts in several jurisdictions, an objection by a defendant to jurisdiction is waived by the act of that defendant in pleading a counterclaim for affirmative relief.

\* \* \*

There are decisions, such as *Hasse v. American Photograph Corp.*, 299 F. 2d 666 (10 Cir. 1962), indicating that such is not the result of pleading a compulsory Counterclaim. *Petitioner has not found any decision in the Ninth Circuit on such a matter.* Under the circumstances, petitioner-defendant should not be required to incur the risk that the filing of its counterclaim would estop and preclude petitioner from preserving and raising its jurisdictional objections by appeal, or otherwise, after final judgment.” (Italics ours)

Both in this Court and the Court below, Union unequivocally declared that the involuntary interposition of a compulsory counterclaim by Dragor could not possibly effect a waiver of its jurisdictional objections or constitute a submission to the *in personam* jurisdiction of the District Court. Quoting Barron and Holtzoff, and a host of

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<sup>3</sup> Dragor’s Statement of Points and Authorities upon its application to this Court for a writ of prohibition will hereafter be designated as Dragor Statement.



cases, it underscored the difference between a compulsory and permissive counterclaim, emphasizing the fact that a compulsory counterclaim, filed under the compulsion of Rule 13, FRCP, could not possibly be deemed a voluntary submission to the *in personam* jurisdiction of the District Court under Rule 12, FRCP (Union Statement, pp. 21-24).

Citing *Hasse v. American Photograph Corporation*, 299 F. (2d) 666 (10th Circ., 1962), and distinguishing the cases cited by Dragor, it concluded that (*Ibid.*, p. 22):

“... the authorities hold without exception that the pleading of a compulsory, as distinguished from a permissive, counterclaim constitutes no waiver of a previously asserted jurisdictional defense.”

Having effected its then objective and coerced Dragor into the filing of its compulsory counterclaim, Union now engages in a complete somersault, without even a pretense of justification or explanation therefor. It now offers as truth what it previously denounced as error. It now condemns as error what it previously affirmed as true. There is no longer, according to Union, any difference between a compulsory and a permissive counterclaim. In its view, Rules 12 and 13, FRCP, do not exist. *Barron* and *Holtzoff* are turned up side down. “Dragor’s action in filing a counterclaim,” we are now told, was “voluntary”. (Union’s Brief, p. 22).

To apprehend the full import of Union’s total repudiation of its prior affirmations, a comparison of the contents of its present and prior briefs will prove illuminating:

(1) *Hasse v. American Photograph Corporation*, 299 F. (2d) 666 (10th Circ., 1962): In its former brief submitted in opposition to Dragor’s application for a writ of prohibition, this Court was told that the Tenth Circuit’s



decision in *Hasse* was a “square holding on the point here in question” (Union Statement, pp. 22-23). Union quoted therefrom at pp. 668-669 as follows (Union Statement, p. 23):

“ . . . To hold that the defense of lack of jurisdiction of the person is waived by asserting a compulsory counterclaim would do violence to the purpose of Rule 12 in negating the necessity of special appearances.”

“Since appellant had no alternative but to submit his claim against the plaintiff along with his defense to appellee’s complaint, *we hold that such compulsion did not constitute* a waiver of his jurisdictional defense.” (Italics ours.)

In its present brief, this Court is now informed that the *Hasse* decision is no impediment to a holding that the interposition of a compulsory counterclaim constitutes a waiver of previously or simultaneously asserted jurisdictional objections and a submission to the *in personam* jurisdiction of the District Court (Union’s Brief, p. 23).

(2) *The authorities cited by Dragor*: Upon its application for a writ of prohibition, Dragor cited three decisions (Dragor Statement, p. 12) which indicated the possibility that the interposition of a compulsory counterclaim in its answer, though involuntary, might be deemed a waiver of its *in personam* jurisdictional objections. *North Branch Products, Inc. v. Fisher*, 284 F. (2d) 611, 615 (Ct. App., D. C. 1960); *Reubens v. Ellis*, 202 F. (2d) 415 (5th Cir., 1953); *Hook & Ackerman, Inc. v. Hirsh*, 98 F. Supp. 477 (D. Ct., D. Col. 1951).

In opposition, at that time, Union declared that those decisions were, in fact, in accord with the decision of the

Tenth Circuit in *Hasse*. Thus, it stated (Union Statement, pp. 23-24):

“The three cases cited by petitioner (Statement, p. 12) *do not support* any different rule. \* \* \*

*North Branch* is in complete accord with the Tenth Circuit decision in *Hasse*. There a waiver was held to have occurred because defendant’s jurisdictional defense was raised by motion long *after* it had filed its answer and counterclaim. The court nevertheless emphasized that no waiver would have occurred had defendant challenged the court’s jurisdiction before filing its answer and compulsory counterclaim. . . .

*Reubens* involved a similar situation in which the defendant sought to raise a venue objection long *after* answering and filing a counterclaim.

In *Hook* the District Court for the District of Columbia commented that the liberality afforded by the Federal Rules in permitting joinder of a jurisdictional defense with a defense on the merits would not appear to extend to a situation in which a counterclaim is filed. *No distinction was made between a permissive and compulsory counterclaim.* This decision, to the extent inconsistent with the above authorities, in effect has been overruled by the subsequent decision of the Court of Appeals for the District of Columbia in the *North Branch* case.” (Italics ours)

This Court is now told that the foregoing decisions, and more particularly *North Branch Products, Inc.* and *Hook and Ackerman, Inc.*, far from being inapplicable, do, in fact, support the “waiver” doctrine and do, in fact, confirm Dragor’s “voluntary” submission to the *in personam* jurisdiction of the District Court (Union’s Brief, p. 22).

(3) *Barron and Holtzoff*: On pages 22-23 of its present brief, Union quotes from Barron and Holtzoff, Federal Practice and Procedure, Vol. 1A, §370.2, p. 535, purporting to formulate the rule that “the assertion of a counter-

claim is a waiver today just as it would have been prior to the Rules." What Union does not advise this Court is that the paragraph of Barron and Holtzoff which it quotes *pertains solely and only to a permissive counterclaim and not a compulsory counterclaim*. It completely omits the paragraph immediately following the quoted paragraph, wherein the authors fully explain what is meant by the text which Union quotes. The following paragraph, *omitted by Union from its present brief*, was the very paragraph which it cited to this Court in its prior brief (Union Statement, p. 22):

"*'What has been said so far deals only with the situation in which the counterclaim is permissive, and where there is some justice in saying that defendant, by voluntarily invoking the jurisdiction of the court on his counterclaim, must be held to have waived his objections to jurisdiction or venue. To apply such reasoning to compulsory counterclaims would be quite a different matter, since there defendant has no choice but is coerced into asserting his claim as a counterclaim. . . . But to find waiver in these circumstances seems something less than fair play, and it is not required by the precedents prior to the rules, where a compulsory counterclaim was unknown. Thus there is merit in those cases which have drawn a distinction, and which have held that the assertion of a compulsory counterclaim is not a waiver of other defenses and objections joined with it.'*"

We do not propose to comment upon the morality of Union's current maneuvers beyond recalling the trenchant words of Lord Kenyon "that a man should not be permitted to 'blow hot and cold' with reference to the same transaction, or insist at different times on the truth of each of two conflicting allegations according to the promptings of his private interest" (quoted in *Smith v. Boston Elevated Ry. Co.*, 184 Fed. 387 at 389, [1st Cir., 1911]). Of a similar tactic, Chief Judge Hutcheson formulated the rationale of



judicial estoppel in *Livesay Industries v. Livesay Window Co.*, 202 F. (2d) 378 (5th Circ.) as follows:

"Further, all questions of reported cases aside, it ought to be, we think it is, clear that, upon every principle of judicial estoppel, including the estoppel arising out of inconsistent positions in legal proceedings, defendant may not, as it attempts to do here, *so trifle with the judicial process*.

By solemn affirmation in the patent office and thereafter by solemn affirmation in its pleadings prepared and filed by the same counsel who represents it in this suit, it affirmed the patentability of the invention and the validity of the patent. By evidence offered and argument made by the same counsel in support of that affirmation, it induced the district judge, upon full and careful consideration, as evidenced by his opinion in *Livesay v. Drolet*, D. C. 38 F. Supp. 885, to hold the patent valid and infringed. . . . Defendant ought to be, we think it is, *completely estopped from doing an about face in this case in the same court and forum and repudiating what it had before as solemnly affirmed there.*" (Italics ours)

Judge Hastie denounced a comparable tactic in *Scarano v. Central R. Co. of New Jersey*, 203 F. (2d) 510 (3rd Circ., 1953) with the following words:

"A plaintiff who has obtained relief from an adversary by asserting and offering proof to support one position *may not be heard later in the same court to contradict himself in an effort to establish against the same adversary a second claim inconsistent with his earlier contention*. Such use of inconsistent positions would most flagrantly exemplify *that playing 'fast and loose with the courts' which has been emphasized as an evil the courts should not tolerate*. (Citing cases) *And this is more than an affront to judicial dignity*. For intentional self-contradiction is being used *as a means of obtaining unfair advantage in a forum provided for suitors seeking justice.*" (Italics ours)



## POINT II

Union's newly advanced argument that "Dragor's action in filing a counterclaim was voluntary" (Union's Brief, p. 22), and that Dragor thereby submitted its person to the jurisdiction of the Arizona District Court (Union's Brief, p. 22-23) is contrary to fact and erroneous in law.

### *A. Union's Argument Is Contrary to Fact.*

In its comprehensive opinion upon the first appeal in this case (No. 20416), reversing the judgment entered by the Arizona District Court against Dragor on June 1, 1965 (361 F. 2d 43; cert. den. by the U. S. Supreme Court, October 10, 1966), this Court meticulously noted the successive measures which Dragor vainly invoked to record its unalterable objection to the *in personam* jurisdiction of the District Court and avoid the interposition of a compulsory counterclaim before its jurisdictional objections had been finally resolved. (Ib., p. 45).

This Court further noted that Dragor filed its answer only after all of these measures had failed; that, as an affirmative defense, it reiterated its position that the District Court had never acquired jurisdiction over its person (Ib., p. 45); and that, in setting forth its compulsory counterclaim, it alleged, as part and parcel thereof, in paragraph 18 of its answer (Ib., p. 45, footnote 2):

" \* \* \* that, to avoid a default in answering, the defendant herein has been compelled to file this counterclaim as a compulsory counterclaim under the Federal Rules of Civil Procedure; and that it is now filing the same herein without waiving or intending to waive the objections which it has heretofore raised and asserted, and has herein alleged, to the jurisdiction and venue of this court."

It is a measure of Union's indefensible position upon this appeal that it should have deemed it necessary to rely upon so unseemly a disregard of the record. We turn to a consideration of the legal hypotheses which Union has sought to fashion from a factually non-existent cloth.<sup>4</sup>

### **B. Union's Argument Is Erroneous in Law.**

Union commences what purports to constitute a review of the law with what it characterizes as "the landmark decision in this field of law", the United States Supreme Court decision in *Merchants Heat and Light Co. v. Clow & Sons*, 204 U. S. 286 (Union Brief, p. 20). That decision was rendered in 1907, approximately 30 years before the Federal Rules of Civil Procedure became effective. Prior to the Rules, "*a compulsory counterclaim was unknown.*" (Barron & Holtzoff, Federal Practice and Procedure, Vol. 1A, §370.2, p. 535). Any counterclaim, whether or not it arose out of the transaction set forth in the complaint, could be asserted in the action or not at the option of the defendant. If a defendant chose to plead a counterclaim, he voluntarily elected to become an actor in the litigation. He was, however, under no compulsion to do so.

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<sup>4</sup> Throughout the course of its brief, Union has deliberately sought to becloud the atmosphere upon this appeal by asserting, as "facts", statements pertaining to the events preceding the New York Settlement Agreement, as well as the Mosher law suit, which are completely baseless. Thus, for example, Mosher did not sue to recover \$300,000 for "fabricated steel sold to the joint venture" as Union claims (Union Brief, p. 4). It sued to recover \$300,000 for fabricated steel sold to Union. It did not contend that "Union, in addition to Dragor and IMI, was liable for payment" as Union claims (Union Brief, p. 4). It contended that Dragor, in addition to Union, was liable for payment. It was not seeking to hold Union "liable for the obligation of Dragor" as Union claims (Union Brief, p. 4). It was seeking to hold Union liable upon its direct, primary and individual promise to pay.

To establish the unfounded nature of almost all of Union's references to the supposed facts would be impossible within the confines of this brief. Nor would it serve to illumine any of the issues presented by this appeal.

Consequently, the Supreme Court properly ruled that, in voluntarily pleading a counterclaim which he was free to plead or not as he chose, a defendant necessarily submitted to the jurisdiction of the Court. Thus, it held:

“ . . . the authorities agree that he is not concluded by the judgment if he does not plead his cross demand, and that whether he shall do so or not is left wholly to his choice. (Citing cases) This single fact shows that the defendant, if he elects to sue upon his claim in the action against him, assumes the position of an actor and must take the consequences. The right to do so is of modern growth, and is merely a convenience that saves bring another suit, *not a necessity of the defense.*” (Italics ours.)

With the formulation by the United States Supreme Court of the Federal Rules of Civil Procedure, and particularly Rules 12 and 13 thereof, the views expressed in *Merchants* became obsolete wherever a compulsory counterclaim exists. Today, a defendant is no longer permitted a choice. He is no longer free to withhold a compulsory counterclaim and assert the same in a subsequent action before another forum. A compulsory counterclaim under Rule 13 *must* be pleaded, else it is forever lost. The coercion effected by Rule 13 obviates the consequences which previously attached to voluntary action, if the constitutional objection to *in personam* jurisdiction is asserted before, or when, the compulsory counterclaim is filed. It is still true, of course, that a defendant who files his compulsory counterclaim without asserting any objection whatsoever to the jurisdiction of the Court over his person, is deemed to have waived any opposition to the constitutional power of the forum.

Not a single decision now extant supports the argument advanced by Union (Brief, p. 22) that a defendant who vehemently and continuously objects to the *in personam*



jurisdiction of a District Court automatically submits to that jurisdiction if, his objections being overruled, he is forced to file a compulsory counterclaim. None of the cases cited by Union enunciating the so-called “*Merchants principle*” (Union’s brief, p. 21) even remotely or inferentially supports any such view.

*Texas & P. R. Co. v. Eastin*, 214 U. S. 153 (1909), decided almost 30 years before the Federal Rules of Civil Procedure, simply held that defendants who voluntarily elected to file a cross bill against a third party in a state court action “invoked the jurisdiction of the state court on their own account and for their own purpose . . . (p. 159) *Freeman v. Bee Machine Co.*, 319 U. S. 448 (1943) merely held that a defendant served in a state court action, who removed the case to the Federal Court and, thereafter, *without any objection to the in personam* jurisdiction of the Court, defended on the merits and filed a counterclaim, “thus invoked the jurisdiction of the court and submitted to it” (p. 453). *American Mills Co. v. American Surety Co.*, 260 U. S. 360 (1922) likewise ruled that a defendant who “was not obliged to set up and prove its action at law under Rule 30”, when it did so, by its affirmative action, “waived its previous objection to the equitable jurisdiction of the Court. . . .”

The decisive and dispositive decision upon this subject under the Federal Rules of Civil Procedure, representing, to quote Union’s language in its prior brief, authorities which “hold without exception that the pleading of a compulsory, as distinguished from a permissive, counterclaim constitutes no waiver of a previously asserted jurisdictional defense” (Union Statement, p. 22) is the decision of the Tenth Circuit in *Hasse v. American Photograph Corp.*, 299 F. 2d 666 (1962). As Judge Lewis there stated, that case squarely presented to the Court for determination the



question of "whether jurisdiction of the person was obtained in a case by appellant's claim to affirmative relief lodged against the plaintiff."

In that case, one White sued the American Photograph Corp. for the wrongful death of her husband, alleging the negligence of one Hasse, an employee of that defendant. The defendant then filed a third party complaint for indemnity against the appellant, the administrator of the estate of Francis Hasse, who had also been killed in the accident. The administrator was served under the Oklahoma long-arm statute by service upon the Oklahoma Secretary of State. The administrator thereupon answered, pleading that the Court was without jurisdiction of his person, and filing a cross complaint against the plaintiff for damages resulting from the death of his decedent. The Court reserved its ruling upon the jurisdictional issues and permitted the matter to be tried before a jury. The jury thereupon returned a verdict in favor of the plaintiff and "found no cause of action upon the appellant's cross complaint." The judgment was satisfied by the American Photograph Corp. and the Court granted a judgment in its favor against the appellant on its cross complaint.

The appellant administrator thereupon appealed, upon the ground that no jurisdiction of his person had ever been obtained by the Court below. The appellee contended that "lack of jurisdiction of the person was waived by appellant by the entry of a cross complaint against the plaintiff". Thus the issue was squarely joined in *Hasse*, an issue presented after a full trial before a jury, in which the appellant had endeavored to obtain a jury judgment against the plaintiff.

Notwithstanding these facts, certainly the strongest case which could possibly be urged to support the theory of

waiver and submission, the Tenth Circuit squarely ruled that “to hold that the defense of lack of jurisdiction over the person is waived by asserting a compulsory counterclaim would do violence to the purpose of Rule 12 in negating the necessity of special appearances”. In reversing the judgment of the Court below because of the absence of *in personam* jurisdiction, the Tenth Circuit held, in language directly applicable to the facts of the instant case (pp. 668-9) :

“Since appellant had no alternative but to submit his claim against the appellee along with his defense to appellee’s complaint, *we hold that such compulsion did not constitute a waiver of his jurisdictional defense.*” (Italics ours)<sup>5</sup>

In *North Branch Products, Inc. v. Fisher*, 284 F. 2d 611 (Cir. Ct. D .C., 1960), cited at p. 22 of Union’s brief, the Circuit Court held that the filing of a compulsory counterclaim constitutes a submission to the *in personam* jurisdiction of a Court *only if the filing defendant had failed to as-*

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<sup>5</sup> Union refers (Brief, pp. 12-13) to the deposition and document production sought by Dragor in April of 1965 *after* the compulsory counterclaim was filed and *before* Union’s motion for a judgment of \$1,037,500. was granted by the District Court. If a trial upon the merits would not constitute a waiver of the *in personam* jurisdictional objections previously asserted, depositions, interrogatories, motions to dismiss the complaint or other steps taken by the compulsory counterclaimant prior to trial would not do so. The authorities have so held. Thus, motions to dismiss on grounds other than lack of *in personam* jurisdiction, for more definite statements and interrogatories (*Martens v. Winder*, 341 Fed. (2d) 197 [9th Circ., 1965]); a motion to dismiss the complaint for legal insufficiency (*Elliott & Sons Co., Inc. v. Nuodex Products Co.*, 243 Fed. (2d) 116 [1st Circ., 1957]); a motion to dismiss the complaint, vacate an attachment and quash a garnishment (*Davis v. Ensign-Bickford Co.*, 139 Fed. (2d) 624 [8th Circ., 1944]); the taking of depositions (*Blank v. Bitker*, 135 Fed. (2d) 962 [7th Circ., 1943]); and the pleading of a counterclaim (*Sadler v. Penn. Refining Co.*, 33 Fed. Supp. 414 (1940)) will not constitute a waiver of *in personam* jurisdictional objections.

sert his jurisdictional objections by motion or answer. Actually, as Union had advised this Court in its prior brief (Union Statement, pp. 23-24), *North Branch Products, Inc., supra*, "is in complete accord with the Tenth Circuit decision in *Hasse*." The remaining decisions cited by Union (Brief, p. 22) were all reviewed by the Circuit Court in *North Branch* and were all distinguished upon the ground that, in those cases, any objection to the *in personam* jurisdiction of the Court had been waived by the defendant's failure to assert such objection by motion or answer. Indeed, after discussing these cases, the Circuit Court emphasized the fact that "where the objection to service is filed with answer which includes counterclaim", cases such as *Keil Lock Co. v. Earl Hardware Manufacturing Co.*, D. C. S. D. N. Y. 1954, 16 F. R. D. 388 hold that the jurisdictional objection is not waived by the interposition of a compulsory counterclaim (284 F. [2d] 611, 615, footnote 8).

In Point I of our opening brief (pp. 19-24), we emphasized the fact that this Court's judgment of reversal on April 7, 1966 constituted a conclusive adjudication that the Arizona District Court never acquired, and could not lawfully exercise, any judicial jurisdiction over the person of Dragor in this lawsuit. As we there pointed out, the record before this Court upon the prior appeal from the judgment of June 1, 1965 disclosed every act performed by Dragor prior thereto, including the interposition of its *in personam* jurisdictional objections, and the filing of its compulsory counterclaim. Under the very authorities cited by Union herein, (*Merchants Heat & Light Co. v. Clow & Sons*, 204 U. S. 286) had Dragor performed any act or filed any pleading which constituted, singly or collectively, a waiver of its jurisdictional objections and a submission of its person to the jurisdiction of the District Court, this Court could not have reversed the judgment of June 1, 1965 and dismissed the complaint. Its reversal of that judgment constitutes an unassailable ad-



judication that Dragor's interposition of a compulsory counterclaim in this case, under the circumstances disclosed by the record, did *not* constitute a submission to the jurisdiction of the Court below, and did *not* confer any *in personam* jurisdiction upon the District Court. (*American Surety Co. v. Baldwin*, 287 U. S. 156, 53 Sup. Ct. 98).

Union's present thinly veiled attempt to reargue this Court's determination of the prior appeal is, of course, impermissible and cannot impair the final and definitive nature of this Court's prior adjudication. Union is not only barred and precluded from any attempt to relitigate "all issues actually raised and decided upon the final appeal but also as to those which could have been raised . . ." (*Angel v. Bulington*, 300 U. S. 183, 186, 187; 67 Sup. Ct. 657 [1947]).<sup>6</sup>

In an effort to avoid the *res judicata* effect of this Court's prior decision herein, Union has evolved the unprecedented thesis that that decision merely related to "the Court's authority to entertain a claim for relief against Dragor on Union's complaint"; (Union Brief, p. 19) that a completely separate issue is here presented; (Union Brief, p. 19) and that this appeal deals solely and only with the question of whether, "although found to be without jurisdiction to grant

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<sup>6</sup> Union's statement, constantly repeated in different form, that "Dragor lost all interest in securing an adjudication of its claim for relief" (Union Brief, p. 13) after the deposition of DeBolt is a calumny designed to prejudice Dragor in the eyes of this Court, precisely as it sought to do on the prior appeal. It was Union, as this court pointed out, who deliberately subjected Dragor to the "hardship of being hauled across the country to defend itself in a suit exclusively predicated upon claims arising in New York" (361 F. (2d) 43, 49). It was Dragor who insisted, from the very beginning, that the Arizona District Court never acquired jurisdiction over its person. It comes with little grace from Union to complain that Dragor, beleaguered by Union's assaults after the void judgment for \$1,037,500. was entered, refused to participate in a trial for fear that Union would repudiate its prior representations and advance the very "waiver" and "submission" contentions which it is now urging upon *this* appeal.



relief on plaintiff's complaint", the District Court "may yet retain and adjudicate any counterclaim, compulsory or otherwise, provided such counterclaim is within the subject matter jurisdiction of the Court" (Union Brief, p. 24).

It is to this unique contribution to jurisdictional theory that we now turn our attention.

### POINT III

**Union's theory that jurisdiction *in personam* is divisible, partial and fragmentary, that *in personam* jurisdiction over a complaint is separate and distinct from *in personam* jurisdiction over a compulsory counterclaim, is completely untenable and fallacious as a matter of law.**

The "preservation of a defendant's personal jurisdiction defense to a plaintiff's claim for relief" (Union Brief, p. 23), argues Union, "is not to be confused with the jurisdiction of the Court to hear and decide Dragor's claim against Union." (Union Brief, p. 12).

Thus, in Union's view, the person of a defendant can, at one and the same time, and before one and the same tribunal, be and not be subject to the *in personam* jurisdiction of the District Court. It is a view which has never before been advanced in this or any other Court. Nor can a single word from any decision, text or commentator be summoned for its support. It is a theory, moreover, which would completely vitiate and destroy Rule 12, F.R.C.P. Obviously, it would be impossible, ever, in any case, to preserve a defendant's *in personam* jurisdictional objection if, when erroneously overruled and the filing of a compulsory counterclaim thereby coerced, he is automatically subjected to the jurisdiction of the Court, no matter how meticulously

he has sought to preserve his constitutional objections under Rule 12.<sup>7</sup> Jurisdiction by error would replace the constitutional mandate of jurisdiction by due process.

None of the authorities cited by Union, commencing with *Vidal v. South American Securities Co.*, 276 F. 855 (2nd Cir., 1922) and ending with *Haberman v. Equitable Life Assurance Society*, 244 F. (2d) 401 (5th Cir., 1955) even remotely hints at the existence of so bizarre a jurisdictional hybrid, the half-in and half-out jurisdiction *in personam* thesis which Union has here espoused.

The foundation of *in personam* jurisdiction is "the physical power" of a sovereign over the person of any individual found within its territorial borders, "although in civilized times it is not necessary to maintain that power throughout proceedings properly begun" (*McDonald v. Mabce*, 243 U. S. 90, 91). In any consideration of *in personam* jurisdiction, its foundation must be "borne in mind" (*McDonald v. Mabce*, *supra*, p. 91). Legally, philosophically or pragmatically, it is impossible to conceive of the exercise of physical power by a sovereign over only part of a person in only part of a lawsuit. It is, juridically, as palpable an anomaly as, in other contexts, a people "half slave and half free" or "a house divided against itself."

Either *in personam* jurisdiction exists as a totality or it does not exist at all. If, by the interposition of its compulsory counterclaim, under Rules 12 and 13, F.R.C.P., Dragor had subjected itself to the physical power of the Arizona District Court for any purpose, it would have subjected it-

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<sup>7</sup> Union complains petulantly that Dragor "even obtained a ruling by the Court below that the counterclaim was legally sufficient" (Brief, p. 12). It was Union who moved to dismiss the compulsory counterclaim for legal insufficiency; Dragor who defended it. No court has ever ruled that a defendant waives his previously asserted personal jurisdictional objections by opposing a motion to dismiss a compulsory counterclaim which the defendant had been forced to file.

self to that power for all purposes. But that issue has already been determined adversely to Union by this Court's prior decision, upon a record which included the existence of Dragor's compulsory counterclaim, as well as the very judgment of dismissal herein appealed from.

None of the cases cited by Union furnish any basis whatsoever for so fanciful a hypothesis. In each of them, the plaintiff had commenced an action in the District Court. By commencing the action, the plaintiff had irrevocably submitted his person to the *in personam* jurisdiction of the Court, regardless of the Court's subsequent disposition of his complaint.

Thus, in *Sachs v. Sachs*, 265 F. (2d) 31, cited by Union at pp. 30-31, Judge Maris emphasized the fact:

"And here the plaintiff, having submitted himself to the jurisdiction of the district court by filing his complaint and appearing therein, put it within the power of the court to render a personal judgment against him on the counterclaim. *Adam v. Saenger*, 1938, 303 U. S. 59; 58 Sup. Ct. 454, 82 L. Ed. 649."

Similarly, Judge Groner, in *Isenberg v. Biddle*, 125 F. (2d) 741 at 744, underscored the fact that:

"In the present case, Isenberg came into the District Court to assert a claim against the United States. When he did so, he submitted himself completely to the jurisdiction of the court that justice might be done with regard to the entire subject matter. *General Electric Co. v. Marvel Rare Metals Co.*, 287 U. S. 430, 435; 53 S. Ct. 202; 77 L. Ed. 408."

Again, Judge Major, in *Switzer Bros., Inc. v. Chicago Cardboard Co.*, 252 F. (2d) 407, 411 (7th Circ., 1958) stressed the fact that the plaintiffs "were in Court by their



own voluntary action" and that the plaintiffs "voluntarily submitted themselves to the Court's jurisdiction."

In each of the cited cases, the *defendant* had appeared *without any objection* to the *in personam* jurisdiction of the District Court and had filed a counterclaim seeking affirmative relief against the plaintiff. In each, the plaintiff's suit was defective for want of subject matter jurisdiction or the lack of indispensable parties. Thus, in *Sachs*, the Court held that, "because the plaintiff was domiciled in Massachusetts at the commencement of the action and not in the Virgin Islands", the District Court "was without jurisdiction to entertain his complaint and it was properly dismissed." Similarly, in *Isenberg*, the complaint was dismissed because of the absence of subject matter jurisdiction. Likewise in *Vidal, Pioche Mines Consol., Switzer Bros.* and *Haberman*, the plaintiff's complaint could not be entertained by the District Court because of the lack of subject matter jurisdiction, the absence of indispensable parties or a statutory prohibition.

In each of those cases, except *Haberman*, it was *the plaintiff* who, after his complaint had been dismissed, sought a dismissal of the counterclaim even though (a) he had himself invoked the *in personam* jurisdiction of the District Court by the institution of his action; (b) the defendant had never objected to the Court's jurisdiction over his person; (c) the defendant's counterclaim was within the *in personam* and subject matter jurisdiction of the Court; and (d) it was the defendant who insisted upon its continuance. Necessarily, then, the Court, in each instance, overruled the objection of the plaintiff and permitted the counterclaim to proceed at the behest of the defendant. In *Haberman*, the defendant pressed his counterclaim for trial without asserting any *in personam* jurisdictional objection. It was only *after* he was defeated at the trial upon the merits



that he advanced his jurisdictional objection *for the very first time*. Obviously, it was much too late.

None of these considerations pertain in the instant case. In the instant case, the plaintiff's failure was not a failure of subject matter jurisdiction but a failure of *in personam* jurisdiction over the defendant. In the present case, the defendant never submitted to the *in personam* jurisdiction of the District Court. In the present case, the defendant did not voluntarily file a counterclaim. In the present case, the defendant adamantly opposed the continuance of the compulsory counterclaim. And finally, in the present case, neither jurisdiction *in personam* exists nor has diversity been alleged in the compulsory counterclaim.

It should be noted, in this connection, that Dragor's compulsory counterclaim does not contain any allegation of diversity. (R. 1, pp. 98-105). The omission was deliberate. It is also fatal to any claim that the compulsory counterclaim possesses an independent jurisdictional base. "Jurisdiction *must exist* within the scope of the *allegations* of the counterclaim . . ." (*Manufacturers Cas. Ins. Co. v. Arapahoe, Drilling Co.*, 267 F. [2d] 5, 8; 10th Circ., 1959). Because the requisite jurisdictional fact has not been pleaded, the compulsory counterclaim does not present, independently, a claim cognizable by a Federal Court. (*Ivey v. Frost*, 346 F. [2d] 115; Rule 8[a][1], F.R.C.P.; Moore's Federal Practice, Vol. 2, §8.07, pp. 1639-1640; Vol. 2, §4.02 [3], p. 953.) We did not propose to furnish Union with the slightest pretext for the claim that the compulsory counterclaim set forth an independent, rather than ancillary, jurisdictional base and was therefore jurisdictionally independent of the complaint, should the latter be dismissed. "But plainly, when jurisdiction is lacking over the primary suit, the defect cannot be cured by a counterclaim of which the court also lacks jurisdiction." (*Goldstone v. Payne*, 94 F. [2d] 855, 857; 2nd Circ., 1938).

## CONCLUSION

A word of caution and warning must here be uttered, lest Union be "hoist by its own petard." If, inconceivably, Dragor's compulsory counterclaim is deemed to have been voluntarily interposed, then Union was obligated, under Rule 13 F.R.C.P., to plead the claim set forth in its dismissed complaint as a compulsory counterclaim in its reply to the compulsory counterclaim filed by Union. (*Great Lakes Rubber Corp. v. Herbert Cooper Co.*, 286 Fed. (2d) 631, 3rd Circ., 1961). Its failure to do so, prior to the entry of the District Court's judgment on December 7, 1965, would constitute a waiver which will bar Union forever from attempting to enforce the same.

It is respectfully submitted that the judgment appealed from be reversed and Dragor be permitted to discontinue its compulsory counterclaim without prejudice.

Respectfully submitted,

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**Certificate of Compliance**

I certify that, in connection with the preparation of this brief, I have examined Rules 18 and 19 of the United States Court of Appeals for the Ninth Circuit, and that, in my opinion, the foregoing brief is in full compliance with those rules.

JOSEPH LOTTERMAN  
Attorney

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IN THE UNITED STATES COURT OF APPEALS  
FOR THE NINTH CIRCUIT

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UNITED STATES OF AMERICA,

Appellant and Cross-Appellee

v.

JOHN HUDSPETH, ET AL.,

Appellees and Cross-Appellants

---

ON APPEAL FROM THE UNITED STATES DISTRICT COURT  
FOR THE DISTRICT OF OREGON

---

BRIEF FOR THE UNITED STATES

---

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BRIEF FOR THE UNITED STATES

---

OPINION BELOW

The district court's judgment and findings of fact and conclusions of law appear at pages 12 through 15 of the reproduced record. Its "Supplemental Conclusion," filed after the record was docketed, is reproduced at R. 30.

## JURISDICTION

Judgment was entered by the district court on November 15, 1965, dismissing the trespass action brought by the United States against the defendants (R. 14).<sup>1/</sup> On November 24, 1965, the United States made a motion for new trial and amendment of findings of fact, conclusions of law and judgment (R. 16), which was denied on December 6, 1965 (R. 18). The district court had jurisdiction under 28 U.S.C. sec. 1345. From the judgment, the United States filed its notice of appeal on January 12, 1966 (R. 19), and the defendants filed a notice of appeal on January 17, 1966 (R. 20). The jurisdiction of this Court rests on 28 U.S.C. sec. 1291.

## QUESTIONS PRESENTED

"Dependent" resurveys of certain lands were made by the Department of the Interior to relocate an original survey made in 1872. The questions presented are:

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<sup>1/</sup> In indicating record references, Volume I will be referred to as "R. ," while Volume II will be designated "Tr. ." The exhibits are found in a third supplemental record reproduced by the Court and will be cited as "Ex. ."



1. Whether a landowner claiming under the original survey has exhausted his administrative remedy to attack the resurvey.

2. Whether judicial review of such an administrative determination is limited to finding whether the administrative decision is supported by substantial evidence and is not arbitrary or capricious.

3. Whether, in any event, the district court erred as a matter of law by rejecting dependent resurveys made in accordance with proper legal standards.

4. Whether the district court's failure to specify the grounds upon which it refused to give effect to the resurvey is reversible error.

#### STATUTES AND REGULATIONS INVOLVED

The pertinent statutes and regulations are set forth in Appendix B of this brief.

#### STATEMENT

The United States brought suit against the defendants for a series of timber trespasses alleged to have occurred over the period of September 1950 through October 1953, on public



domain lands in Township 11 South, Range 19 East, Willamette Meridian, Oregon (R. 1). The extent of the alleged trespasses amounted to \$27,377, and a judgment for double that amount was sought under Ore. R.S. sec. 105.815; 43 C.F.R. sec. 9239.0-8 (revised as of January 1, 1965) (R. 2, 7, 8; Tr. 80). In a pre-trial order, the areas cut, designated by section or quarter section, etc., were agreed to, as well as the unit value of the timber cut. It was also agreed that original surveys in the area were made in 1871, 1872 and 1881. It was further agreed that dependent resurveys were made in 1959 (approved 1960) and in 1962 (approved 1964) (R. 8). The issues posed by defendants' claim were in essence that the original surveys established the defendants' rights and that the resurveys did not follow the original surveys (R. 9). Aside from the resurvey issue, the only other question was value of timber cut from government lands (R. 9). This latter issue evaporated at the trial (Tr. 79-80).

The facts concerning survey and resurvey will be more fully developed in the Argument, infra. In short, they show that the defendants owned or had timber cutting rights

on lands patented from public lands adjacent to lands still federally owned. The original boundaries were officially set by John S. Kincaid in 1872 (Fdg. 3, R. 8, 13; Tr. 3, 4). Over the years these lines became increasingly difficult to determine. In 1958 and 1962, the Department of the Interior ordered dependent resurveys to reestablish the original lines of the original public lands survey (Ex. 7, 8; Tr. 11, 12). The instructions, in part, read (Ex. 7, pp. 1-2; Ex. 8, p. 2):

You will carefully retrace the lines authorized for resurvey, employing strict care in the matter of alignment and measurement, exercising due diligence with respect to any evidence of the original survey, making thorough and exhaustive search for the recovery of all original corners and satisfying yourself with reasonable certainty that no such evidence is overlooked.

The dependent resurveys were reviewed with approval by the Chief of the Branch of Cadastral Engineering, Bureau of Land Management, for the States of Oregon and Washington (Tr. 86-103). They were officially accepted (Fdg. 3, R. 8, 13). The original lines, as indicated by the dependent resurveys, brought to light the timber trespasses resulting in this suit.



At the trial, the United States proved through Exhibits 6-8 and through the testimony of Floyd A. Brooks (Tr. 10, 12, 27-28) and others (Tr. 89) that the dependent resurveys of the original Kincaid survey were conducted for the sole purpose of reconstructing and reestablishing the lines of the original survey as made by Kincaid in 1872. Brooks conducted the dependent resurveys of the boundaries in question (R. 10-12). He was a cadastral surveyor with the Bureau of Land Management and had had over 14 years of surveying experience (Tr. 9-10); he was a graduate of the Oregon State Institute of Technology where he took a program in survey technology (Tr. 9) and is a licensed surveyor in the State of Oregon (Tr. 10).

The dependent resurveys took Brooks, with a team of five men, over five months to complete (R. 8; Tr. 38). In his own words, conducting a dependent resurvey amounts to "a reconstruction of the original survey on the ground to reestablish or remonument the original corner positions" (Tr. 10). A summary of this step-by-step process, as presented at the trial, can be found in Appendix A of this brief.

The defendants admitted that they may have been trespassers on some of the land involved (Tr. 159-160). In presenting their case, no attempt was made to prove where the original lines exist or that they exist in any place other than where the dependent resurveys place them (Tr. 104-158). Instead, the defendants confined their case to criticism of the government resurveys, with some criticism of the original survey as being incomplete. They attempted to show that the original corners, as found by Brooks, might not be original corners (Tr. 107, 119): the area was rocky and the basalt stones uncovered by Brooks could be plain stones and not monuments (Tr. 134).

The Hudspeths' key witness, Gail Thomas, lacked any experience in handling resurveys (Tr. 140) and never attempted to resurvey the land in question (Tr. 138):

Q. (Mr. Borgeson): In other words, you haven't attempted to resurvey any portion of the township yourself, have you?

A. (Gail Thomas): I have not.

Q. You haven't attempted to take Mr. Kincaid's notes and follow them on the ground?

A. No.



The Hudspeths' logging superintendant testified that to establish their timber cutting area they took the west boundary of the township, as surveyed by Thompson, and projected therefrom the lines indicated by Kincaid's original field notes (Tr. 145-148). Indications of the boundaries on the ground were never found (Tr. 148). Evidence as to where these projected lines fell upon the ground was never presented to the court.

The district court, in disagreement with the defendants' evidence, found that the defendants were in fact trespassers according to the original Kincaid survey (Fdg. 3; R. 13). However, the court went on to state that the United States brought this action based upon dependent resurveys and the defendants are not bound by them (Fdg. 3; R. 13). The court did not state that the dependent resurveys were not conducted in accordance with proper legal standards or were erroneous. The action was dismissed "without prejudice" to the right of the plaintiff to institute an action based on the Kincaid survey (Judgment, R. 14; Concl. of Law, R. 13). After the appeal was docketed, the court added a conclusion of law as follows (R. 30):

My theory in holding the plaintiff to the Kincaid survey is premised on authorities such as Cragin v. Powell, 128 U.S. 691 (1888), holding that after the sovereign has sold and disposed of lands pursuant to a certain survey, the courts have power to protect the private rights of the party who has purchased in good faith from the Government against the interferences or appropriations of corrective resurveys made subsequent to disposition or sale. Here, the resurveys on which the plaintiff depends were made subsequent to the alleged trespasses.

### SUMMARY OF ARGUMENT

1. Exhaustion of available administrative remedies is required before judicial consideration will be given. Failure to exhaust administrative remedies is especially fatal in highly specialized and technical matters. This is certainly the case with dependent resurveys which draw upon an understanding of geography, surveying, mathematics and engineering. The validity of dependent resurveys conducted by the Department of the Interior to reestablish original boundaries must be appealed directly to the Director of the Bureau of Land Management and the Secretary of the Interior before resort to the courts. Here, premature judicial consideration and prejudicial error resulted from the Hudspeths' failure to pursue administrative appeals and instead collaterally attacking the



dependent resurveys conducted in 1959 and 1962, to reestablish boundaries originally set in 1872, in the district court in 1964.

2. Even when courts consider such matters, the judicial function is narrowly limited. The courts will only determine whether the administrative determination is arbitrary or capricious. In this way the congressional delegation of power to the Secretary of the Interior is honored and the end product is greater uniformity. The district court should not have viewed the matter any broader merely because the required administrative appeals were not taken.

3. The legal standards for conducting dependent resurveys under federal and Oregon law are set forth in the Manual of Surveying Instructions (Dept. of the Interior, 1947). When so properly conducted, earlier vested rights in land are not altered or changed but simply are reestablished. The test of a valid dependent resurvey is whether it was properly conducted and is not a de novo comparison with field notes or

plats. Only the dependent resurvey evaluates, coordinates and reconstructs the existing indications of the original survey in order to arrive at the reestablishment of the original boundaries on the ground. Thus, where resurveys are made in accordance with the Manual, they are conclusive as having retraced the original boundaries on the ground. Refusal of the district court to treat them as original boundaries is error as a matter of law.

4. A district court sitting without a jury is required by Rule 52(a), F.R.Civ.P., to state the basis for its conclusions and judgment. Failure to do so is reversible error, as in this case, because there is no way to determine whether the court's action was founded upon correct legal premises. The memorandum filed after the appeal was docketed indicates it was not.



## ARGUMENT

### I

#### ADMINISTRATIVE REMEDIES WERE NOT EXHAUSTED

It is a well-established principle of law that no one is entitled to judicial relief until his prescribed administrative remedies have been exhausted. Myers v. Bethlehem Shipbuilding Corp., 303 U.S. 41, 50-51 (1938); Davis v. Nelson, 329 F.2d 840, 847 (C.A. 9, 1964); Coy v. Folsom, 228 F.2d 276, 280 (C.A. 3, 1955); Union Oil Co. of California v. Federal Power Commission, 236 F.2d 816, 818-819 (C.A. 5, 1956), cert. den., 352 U.S. 969 (1957).

Here, the Hudspeths failed to exhaust their administrative remedies. Had they believed that their rights were adversely affected by the 1959 and 1962 dependent resurveys of the original Kincaid survey, they could have appealed directly to the Bureau of Land Management and then to the Secretary of the Interior. 43 C.F.R. secs. 1842, 1844 (revised as of January 1, 1966) (App. B, infra, pp. 49-50). They did not do this. Instead, they waited until the United States brought a trespass action in August 1964, and then collaterally attacked the validity of the official dependent resurveys. A collateral attack, by its very nature, is in

itself forbidden. Gardner v. Bonestell, 180 U.S. 362, 369 (1901); Knight v. United States Land Association, 142 U.S. 161, 176 (1891); Cragin v. Powell, 128 U.S. 691, 699 (1899); Hallaian v. Collins, 242 P.2d 58, 59 (Cal.App. 1952); see generally Memorandum of the United States as amicus curiae <sup>2/</sup> in Placid Oil Co. v. Union Producing Co. (O.T. 1966, No. 85).

The administrative decision carries great weight in cases of this nature and administrative processes must not be circumvented because the making of dependent resurveys calls for a specialized understanding and technical knowledge of geography, surveying, mathematics and engineering. It takes someone with this expertise (a cadastral surveyor) to evaluate, coordinate and reconstruct the existing indications of the original survey in order to arrive at the reestablishment of the original boundaries on the ground. Ample supervision is provided: "The official resurveys are undertaken only when duly authorized, and the field work assigned to a cadastral engineer, who in that manner is acting under the

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<sup>2/</sup> Copies of this Memorandum for the United States filed in the United States Supreme Court on a pending case at the request of the Court, 384 U.S. 937, have been filed with the clerk and served upon opposing counsel. It states the position of the United States concerning surveying questions.



authority of the Secretary of the Interior through the Bureau of Land Management and under the immediate direction of subordinate supervising officers." Manual of Surveying Instructions (Dept. of the Interior, 1947) sec. 390, p. 311.

As spelled out in the Placid Oil memorandum, supra, this entire subject of surveys of lands located in the United States outside the original colonies has been, since 1796, a matter entrusted originally to the Surveyor General, now to the Bureau of Land Management. It is so exclusively a matter in the expertise of that office that the results are, generally speaking, not subject to any review by the court. See Placid memorandum, p. 7. Resurveys are just as much within the scope of that expertise as are original surveys (Id; pp. 5-6), limited only by the fact that vested rights cannot thereby be altered. The regulations recognize the obvious fact that resurveys are simply one aspect of the entire surveying picture and are properly within the competence of the federal surveying agency. Thus, as stated in 43 U.S.C. sec. 2:

The Secretary of the Interior or such officer as he may designate shall perform all executive duties appertaining to the surveying and sale of the public lands of the United States, or in anywise respecting such public lands, and, also, such as relate to private claims of land, \* \* \*.

"The Secretary of the Interior, or such officer as he may designate, is authorized to enforce and carry into execution, by appropriate regulations, every part of the provisions of this title not otherwise specially provided for."

43 U.S.C. sec. 1201. "The official resurveys are undertaken only when duly authorized, and the field work assigned to a cadastral engineer, who in that manner is acting under the authority of the Secretary of the Interior through the Bureau of Land Management and under the immediate direction of subordinate supervising officers." Manual, sec. 390, p. 311.

The resurveys are "to be regarded as an official demonstration, on the part of the Bureau of Land Management, in the light of the best evidence available, by means of the legal subdivisions of a dependent resurvey or by the tract segregations of an independent resurvey, of the original position of entered or patented legal subdivisions or lots included in the original description when related to the original survey."

Manual, sec. 402, p. 317.



Thus, exhaustion of administrative remedies by appeal to the Director of the Bureau of Land Management and to the Secretary of the Interior from resurveys, as existed in this case, rather than collateral attack in a district court, was the required remedy. Then, if still aggrieved, the defendants could have resorted to the courts. Foster v. Seaton, 271 F.2d 836, 837 (C.A. D.C. 1959).

## II

### THE ADMINISTRATIVE DECISION IS NOT SHOWN TO HAVE BEEN ARBITRARY OR CAPRICIOUS

The limited function of the courts in reviewing determinations of the Secretary of the Interior is clearly recognized. The courts determine whether the administrative action is arbitrary or capricious. Cameron v. United States, 252 U.S. 450, 459-461, 464 (1920); Boesche v. Udall, 373 U.S. 472, 476-477 (1963); Best v. Humboldt Mining Co., 371 U.S. 334, 335-336 (1963); Standard Oil Co. of California v. United States, 107 F.2d 402, 410 (C.A. 9, 1940), cert. den., 309 U.S. 654; Morgan v. Udall, 306 F.2d 799, 801 (C.A. D.C. 1962), cert. den., 371 U.S. 941; Safarik v. Udall, 304 F.2d 944, 950 (C.A. D.C. 1962), cert. den., 371 U.S. 901; Asenap v. Huff, 312 F.2d 358, 359 (C.A. D.C. 1962). Certainly no broader

review is permitted in a collateral attack of the Department's decisions where the defendants failed to exhaust their administrative remedies than would be permitted in direct proceedings following a final administrative determination by the Secretary of the Interior.

"[G]reat confusion and litigation would ensue if the judicial tribunals, state and federal, were permitted to interfere and overthrow the public surveys on no other ground than an opinion that they could have the work in the field better done, and divisions more equitably made, than the department of public lands could do." Haydel v. Dufresne, 58 U.S. (17 How.) 22, 30 (1854). The courts must guard against destruction of "the unified administration attained by the creation of a single agency and to make of the eleven courts of appeals eleven super agencies." National Labor Relations Bd. v. Southland Mfg. Co., 201 F.2d 244, 246 (C.A. 4, 1952).

In reversing the lower courts' decisions in Railroad Commission of Texas v. Rowan & Nichols Oil Co., 310 U.S. 573 (1940), a case involving great technical expertise, the Supreme Court stated (pp. 581-583): "Both the District Court



and the Circuit Court of Appeals appear to have been dominated by their own conception of the fairness and reasonableness of the challenged order \* \* \*. These touch matters of geography and geology and physics and engineering \* \* \*. Plainly these are not issues for our arbitrament." A similar situation exists here in the district court.

If anything, the district court should have addressed itself to the problem of whether the dependent resurveys were supported by substantial evidence and were not arbitrary and capricious, i.e., whether they were conducted in accordance with the standards required by law. There has been a complete failure of the district court to so view the problem.

There is nothing in the record to indicate that the resurveys were arbitrary or capricious. The district court made no such finding. As indicated in Appendix A, the resurveys were carefully and thoroughly conducted in accordance with proper legal standards. This is not matter which can be shown by mathematical certainty. Appellees nowhere showed that the result was not a reasonable one on the facts. It should, therefore, have been respected by the court.

### III

DEPENDENT RESURVEYS MUST BE ACCEPTED  
AS HAVING REESTABLISHED THE ORIGINAL  
BOUNDARIES WHEN CONDUCTED IN ACCORDANCE  
WITH THE MANUAL OF SURVEYING INSTRUCTIONS

A. Under federal and Oregon law, the Manual sets

forth the standards and procedures for conducting surveys. -

The Manual of Surveying Instructions (United States Department of the Interior, 1947), as the introduction points out (p. III), "is issued for the guidance of all employees who exercise a technical responsibility in the execution of cadastral surveys or resurveys \* \* \* [and] will supersede all previous instructions or regulations \* \* \*." Thus, the Manual is the standard by which the Federal Government determines the validity of surveying techniques.

This standard has also been adopted by the western states. The laws of the State of Oregon, for instance, charge the county surveyors to make surveys of legal subdivisions "in accordance with the laws and regulations of the General Land Office (Bureau of Land Management) of the United States." Ore. R.S. sec. 209.070(6). Oregon law also provides that, where title to land is in dispute, the court can order the



county surveyor to conduct a survey or resurvey of the disputed land. Ore. R.S. sec. 209.020. Such survey by the county surveyor would have to be made pursuant to law, and, therefore, in accordance with the Manual.

In Cramer v. Driesbach, 287 P.2d 981 (Idaho 1955), the plaintiff's cadastral survey was conducted in accordance with the Manual and was the only comprehensive and accurate survey. The Supreme Court of Idaho held (p. 985): "In such a state of the record, the trial court was bound to accept the lines as [so] located." In that case, the defendant's evidence which the trial court accepted was rejected by the appellate court because it was incomplete and did not comply with the Manual.

B. The defendants were negligent in not following the appropriate methods for determining boundaries. - It is the duty of the person causing timber to be cut to determine the location of his boundary line in advance of the cutting. Gordon Creek Tree Farms, Inc. v. Layne, 368 P.2d 737, 741 (Ore. 1962); Longview Fibre Co. v. Johnson, 238 P.2d 722, 728-729 (Ore. 1951); United States v. Firchau, 380 P.2d 800

(Ore. 1963); United States v. Hult, 319 F.2d 47 (C.A. 9, 1963). Trespassers cut beyond their boundaries at their peril. This policy is necessary because of the policing difficulties encountered by government agencies in administering and protecting the vast timber lands of the United States and the state governmental agencies.

Here the method used by the defendants to determine the area in which they could cut timber was haphazard and was not in accordance with the Manual. The defendants took the corners of the west boundary of the township, as surveyed by Thompson, and projected lines easterly by record bearings and distances of Kincaid (Tr. 145-148). The west boundary of the township is the only side not originally surveyed by Kincaid (Tr. 19, 145). If there is one township boundary least likely to coordinate well with the subdivisional lines, it is the west boundary. Moreover, this procedure completely ignores the Kincaid interior monuments and the exterior township boundary monuments. No indications of the original boundaries were uncovered on the ground using this method (Tr. 148). This is a good indication of how incorrect the defendants' procedure was. It was also completely inconsistent with the procedure as set forth in the Manual, sec. 348, p. 282 - sec. 427, p. 327.



Furthermore, the record does not reveal any attempt by the defendants to comply with 43 C.F.R. sec. 9185 to request the Federal Government to resurvey the boundaries. All the record reveals is a vague one-sentence assertion by the defendants' logging superintendent that the Bureau of Land Management was called (Tr. 145).

The fact that the defendants acted in good faith and attempted to establish some sort of boundaries does not exonerate them. This is immaterial because they cut timber and were under a duty to correctly locate the property boundaries and are liable as trespassers for failure to do so. Gordon Creek Tree Farms, Inc. v. Layne, 368 P.2d 737 (Ore. 1962) and cases supra, pp. 20-21. Their good faith only bears on the measure of damages and not upon liability.

C. The dependent resurveys properly reestablished the lines of the original survey on the ground, since they were conducted in accordance with the Manual. - A dependent resurvey is defined in the Manual (sec. 400, p. 315) as:

\* \* \* a restoration of what purports to be the original conditions according to the record, based, first, upon identified existing corners of the original survey and other recognized and acceptable points of control, and, second, upon the restoration of missing corners by proportionate measurement in harmony with the record of

Its object is two fold (Manual, sec. 387, p. 309):

First, the adequate protection of existing rights acquired under the original survey in the matter of their location on the earth's surface, and, second, the proper marking of the boundaries of the remaining public lands.

When the district court found that the defendants were not bound by the dependent resurveys, but suit could still be brought on the "Kincaid survey", it illustrated its misunderstanding of the very nature of a dependent resurvey (Fdgs. & Concl., R. 13). This misunderstanding was further amplified by (1) the finding that the defendants did in fact trespass on the public lands of the United States on the basis of the Kincaid survey and (2) the court's act of dismissing the Government's case because it was based upon dependent resurveys of the Kincaid survey and not the original survey itself. (Fdgs. 3, R. 13).<sup>3/</sup>

The simple fact is that this suit was instituted "based on the Kincaid survey" (R. 9). A dependent resurvey cannot be contrasted with the original survey it is attempting

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<sup>3/</sup> The basis for the court's conclusion to reject the dependent resurveys was not revealed. For discussion of the inadequacy of the district court's findings see pp. 28-32 of this brief.



to reestablish. The two are indistinguishable because the dependent resurvey is the original survey on the ground. Only the dependent resurvey takes the plats and field notes of the original survey and coordinates them with existing evidence on the ground. It replaces on the ground as near as it can the survey made 90 years earlier.

By its very nature, a dependent resurvey is caused by the fact that there are gaps to be filled in, but rather than fill them in as though the entire survey was performed correctly, they are filled in as they previously existed under the original survey. When bona fide rights of private parties are involved, the cadastral surveyor pieces together the best available evidence to arrive at "the original position of entered or patented legal subdivisions or lots included in the original description when related to the original survey." Manual, sec. 402, p. 317; see Ayers v. Watson, 137 U.S. 584, 600-601, 604 (1891); Galt v. Willingham, 11 F.2d 757, 758 (C.A. 5, 1926); Vaught v. McClymond, 155 P.2d 612, 616 (Mont. 1945); Trustees of the Internal Improvement Fund of the State of Florida v. Toffel, 145 So.2d 737, 741-742

(Fla. 1962); J. M. Beard, 52 L.D. 451, 453 (1928); B.L.M. decision, Lawrence H. Newton, No. 47-80036, 5.04g (1960); B.L.M. decision, H. M. Meloney, No. 47-72797, 5.04g (1958).

As pointed out in Lawrence H. Newton:

\* \* \* the objective of the resurvey is the restoration of the corners in their true position from the best available evidence of the original survey. That may consist of physical evidence of the corner or its accessories; collateral evidence such as supplemental survey records, evidence of improvements related to the lines and corners of the survey, testimony of settlers having knowledge of conditions respecting the corners, etc. Reestablishment of a corner by proportionate measurement is a last resort and is employed where there is no other reasonable basis for determining the position of the corner  
\* \* \*.

The decision further pointed out that the party claiming before the Department that the dependent resurvey was invalid must make a showing:

\* \* \* based not on conjecture, but upon a demonstration that there is some identifiable point of land more likely to have been the site of the original corner than the particular site chosen by the cadastral engineer. \* \* \*

Since the procedure prescribed by the Manual for reestablishing a corner was followed, and since the appellant has made no showing



that the corner established thereby is not correct, the decision of the Area Administrator, dismissing the protest, is affirmed.

Thus, a dependent resurvey performed in accordance with the Manual does not affect or change prior existing rights in the land. It establishes what those rights have always been. This stands in sharp contrast to a new or corrective survey which ignores the earlier original survey and, as with all surveys, cannot change prior existing interests in the land. United States v. State Investment Co., 264 U.S. 206, 212 (1924) Cragin v. Powell, 128 U.S. 691, 699-700 (1888). The defendants have argued that their rights were interfered with, yet they never showed the court what those rights were. They did not present any evidence as to where, on the ground, the boundaries exist other than where the dependent resurveys place them.

Then, the critical issue in determining the validity of a particular dependent resurvey is: whether the dependent resurvey was conducted in accordance with those standards established by law, that is, the Manual. How else could one test the accuracy of a dependent resurvey but to see whether it was performed in accordance with acceptable legal standards?

There is nothing else on the ground with which to compare it. The district court ignored this standard and merely presented its conclusion that the defendants should not be bound by the dependent resurveys (Fdg. 3; R. 13).

This discussion as to the very nature of a dependent resurvey should not be cast aside as a factual matter for which a finding must be clearly erroneous to be overturned. We are concerned with the legal standard to be applied when the validity of a dependent resurvey is at issue. United States v. General Motors Corporation, 384 U.S. 127, 141 fn. 16 (1966), pointed out that the ultimate conclusions of a trial judge are not to be shielded by the "clearly erroneous" test of Rule 52(a), F.R.Civ.P. "[T]he question here is not one of 'fact,' but consists rather of the legal standard required to be applied to the undisputed facts of the case." The court went on to state: "\* \* \* the trial court's customary opportunity to evaluate the demeanor and thus the credibility of the witnesses, which is the rationale behind Rule 52(a) \* \* \* plays only a restricted role here. This was essentially a 'paper case.'"



In short, the fact is perfectly clear that, had this record been made in departmental proceedings, the dependent resurveys would have been approved. The result should be no different when a court undertakes to decide the matter.

#### IV

#### THE SPECIFIC BASIS FOR THE RESULT OF A JUDGE-TRIED CASE MUST APPEAR

Rule 52(a) of the Federal Rules of Civil Procedure requires that a district court in a non-jury case "find the facts specially." The Supreme Court has construed that provision to mean that the district court must make findings, "in such detail and exactness as the nature of the case permits, of subsidiary facts on which the ultimate conclusion \* \* \* can rationally be predicted." Kelly v. Everglades Drainage District, 319 U.S. 415, 420 (1943); see Commissioner v. Duberstein, 363 U.S. 278, 292 (1960); Hatahley v. United States, 351 U.S. 173, 182 (1956); Dalehite v. United States, 346 U.S. 15, 24 fn. 8 (1953). The underlying policy for requiring triers of fact to state sufficiently detailed findings is to provide a basis for review.

As early as 1870, the Supreme Court stated in Miller v. Life Insurance Co., 79 U.S. (12 Wall.) 285, 301, that the review of special findings extends to the determination of the question "whether the facts found are sufficient to support the judgment" and "it is well settled law that the finding must be sufficient in itself without inferences or comparisons, or balancing of testimony or weighing evidence."

The district court, by rejecting the dependent resurveys without stating the basis for its decision, precluded any possible review on the merits.<sup>4/</sup> Its result is little more than would be a jury verdict. The district court did not find either that:

- (1) Kincaid never originally laid boundaries or interior corners; <sup>5/</sup> or

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<sup>4/</sup> The conclusory findings the court did make are in themselves contradictory (Fdg. & Concl. 3, R. 13). It said the Hudspeths trespassed according to the Kincaid survey; that the dependent resurvey of the Kincaid survey is not applicable; but that the United States could bring an action based upon the Kincaid survey. The court makes no finding that the resurveys were not properly done. To the contrary, the facts indicate that the Manual's requirements were met.

<sup>5/</sup> Just the opposite is indicated by the court's finding that the Hudspeths did, in fact, commit trespasses according to the Kincaid survey (Fdg. 3; R. 13).



- (2) the United States did not follow prescribed rules and regulations in running the dependent resurveys of the Kincaid survey; or
- (3) the United States failed to evaluate or incorrectly evaluated evidence going into the dependent resurveys; or
- (4) the original survey can be placed on the ground any more accurately than the United States has done.

Making no specific findings as to inadequacies, the court in no way indicates what could be cured by a new suit.

This failure to make specific findings renders the dismissal without prejudice deceptive. The court did not dismiss the complaint on the basis of errors in the conduct of the dependent resurveys for which the Department of the Interior could have done a better job. The court apparently accepted the Government's position that the dependent resurveys were accurately performed in accordance with legal standards. It simply refused to apply them to the defendants. Not until the district court filed a supplemental conclusion after the record was docketed (R. 30) was any indication given as to why it rejected the dependent resurveys of the Kincaid survey. The crux of its decision appears in the assertion: "Here, the

resurveys \* \* \* were made subsequent to the alleged trespasses." <sup>6/</sup> This is an anomalous and rather paralyzing result--how else could the original survey performed in 1872 be reestablished on the ground today and the fact of trespass shown? The very reason for the dependent resurvey was to establish the Kincaid survey on the ground. A dependent resurvey, properly conducted in accordance with the Manual, is the best evidence of the original survey on the ground and stands in place of the original survey. Although the court suggested that the Government might bring a new trespass action based upon the Kincaid survey, that would be nugatory. The effect of the court's decision is to condone the trespass of the defendants on the public domain

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6/ The district court cited Cragin v. Powell, 128 U.S. 691 (1888), for upholding this conclusion. However, Cragin simply holds that where parties have definite rights in land, those rights cannot be altered or changed by later surveys. Here the dependent resurveys do not alter any pre-existing rights in the land--the defendants presented no evidence that their vested interests were anywhere other than where the resurveys placed them. The resurveys simply reestablished what those rights have always been under the original Kincaid survey. This case is brought on the basis of the Kincaid survey. That survey determined the boundary lines. The object of the resurvey is to furnish proof of the location of lost lines or monuments, and not to dispute the correctness of or to change the original survey.



because the Government has no way of proving its boundaries at the time of trespass other than by dependent resurveys. To permit such a result to stand reverses the obligations of the parties. The very point of the timber trespass laws, particularly the double and triple damages provisions, supra, pp. 20-22 is to impose on the lumberman the duty not to trespass on government property. The district court would reverse this and impose upon the Government the duty to vigilantly watch all of its properties and resurvey them when necessary to catch future trespassers, allowing those occurring before the resurvey to go uncompensated.

#### CONCLUSION

For the foregoing reasons, it is submitted that the judgment below should be reversed and the case remanded to the district court with detailed instructions in accordance with the law.

Respectfully submitted,

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Assistant Attorney General.

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ROGER B. MARQUIS

## APPENDIX A

### Determination of Floyd A. Brooks

The following highlights from the direct examination of Brooks can only be properly understood when read in conjunction with the instructions and dependent resurveys themselves (Ex. 7, 7A, 8 and 8A) which were offered and received into evidence (Tr. 11).

Floyd A. Brooks was a cadastral surveyor with the Bureau of Land Management, Department of the Interior (Tr. 9). He was graduated from Oregon State Institute of Technology, where he took a two-year program in survey technology (Tr. 9). He is a licensed surveyor in Oregon and has had over 14 years' surveying experience (Tr. 10). He conducted the resurveys of portions of Township 11 South, Range 19 East, according to instructions from the Bureau of Land Management (Tr. 10-12; Ex. 7, 8). In essence, this amounts to "a reconstruction of the original survey on the ground to re-establish or remonument the original corner positions" (Tr. 12). As to the procedure followed in conducting the dependent resurveys, Brooks pointed out (Tr. 28): "The original corners as located [are] the major control[s] in all cases. \* \* \* [I]n the process of looking for



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these original monuments, we would take into consideration any calls of topography. Now, these calls of topography cannot be used to re-establish a corner, but they can be used to verify corner position. And if unable to find an original corner from any of this type of information, then we would look for local or County surveyor corners; 'local' meaning corners established by a private surveyor and recorded."

The retracement of the lines of the original survey was commenced at the corner of Sections 25, 30, 31, and 36, on the west boundary of Township 11 South, Range 19 East (Tr. 13). Brooks surveyed a random line East, a distance of one mile, between Sections 30 and 31 (Tr. 13). He found neither the quarter-section corner or the corner of Sections 29, 30, 31, and 32 as established by Kincaid (Tr. 13). He turned South, on a random line between Sections 31 and 32 (Tr. 13). Again, he found no corners on this mile (Tr. 13). He then retraced West one mile, on the south boundary of Section 31, failing to find the quarter-section corner but recovering the southwest corner of Section 36, which is also the southwest corner of the township (Tr. 13). Next, Brooks returned

to his temporary southeast corner of Section 31, from which he retraced East on the south boundary of the township along the south boundary of Sections 32 and 33 (Tr. 14). He found no corners until he had gone two miles, where he located a basalt stone, 14 by 8 by 6 inches, loosely set four inches in the ground at a fence corner from which fences extended North, South, and East; the stone had three grooves chiseled on the west face (Tr. 14; Ex. 7A, p. 1). At a distance of 23 links, S.  $51\frac{1}{4}^{\circ}$  E. from the marked stone, Brooks found a juniper tree, 15 inches in diameter, with the marks "T12S R9 S3" scribed on a partly healed blaze; he had no record of any witness tree for this corner (Tr. 15; Ex. 7A, p. 1).

From his temporary point for the corner of Sections 4, 5, 32, and 33, on the south boundary of the township, a mile West of the marked stone, Brooks retraced North between Sections 32 and 33, but found no corners on this mile of line (Tr. 15). He turned West for one mile between Sections 29 and 32 to connect up with his temporary corner of Sections 29, 30, 31, and 32, still failing to find corners (Tr. 15). Returning to his temporary corner of Sections 28, 29, 32, and 33,



he retraced East between Sections 28 and 33, but again found no corners (Tr. 15). He therefore continued to retrace East between Sections 27 and 34, to the corner of Sections 26, 27, 34, and 35 (Tr. 15). Here he found a basalt stone, 24 by 16 by 6 inches, lying on its side in a small mound of stone, at the corner of barbed wire fences extending North and West; the stone had one groove chiseled on the south face (Tr. 15; Ex. 7A, p. 20). The size of this stone agrees with Kincaid's record (Ex. 6A, p. 14).

This manner of retracing the lines of the original survey was in accordance with the Special Instructions for Survey Group No. 421, Oregon, dated October 7, 1958 (Ex. 7). These named the boundaries of public land to be resurveyed; they gave history of the previous surveys, and outlined the methods by which the surveyor was to proceed (Ex. 7, pp. 1 and 2). He was to be (Ex. 7, pp. 1, 2):

\* \* \* guided by the Manual of Surveying Instructions, 1947, the provisions of the following special instructions, and such supplemental instructions as may be issued pursuant to the report of complications developed during the progress of the work, or by reason of additional authorization.

\* \* \* \* \*

You will carefully retrace the lines authorized for resurvey, employing strict care in the matter of alignment and measurement, exercising due diligence with respect to any evidence of the original survey, making thorough and exhaustive search for the recovery of all original corners and satisfying yourself with reasonable certainty that no such evidence is overlooked and marking temporary points for those corners that are not found with sufficient permanence so that their subsequent recovery and conversion to permanent monuments can be accomplished with a minimum of cost and effort.

\* \* \* \* \*

You will extend your retracements to the boundary lines of adjacent sections in any cases where such action becomes necessary in the development of control for the restoration of any corner of the sections herein provided for dependent resurvey, in which cases you will rehabilitate the control corners by remonumentation, setting standard iron corner monuments in conformity with Manual procedure.

Any and all lost corners of the sections for resurvey will be restored by the appropriate method of proportionate measurements which are described in detail, along with other pertinent matter, in Secs. 348 to 408, inclusive, of the Manual.

It is immaterial at which corner your retracements are initiated, nor is the order in which they are made important; however, your field notes and any reports submitted will be so arranged that the results of the examination and resurvey will appear in the record in regular order.



Brooks continued his retracements in accordance with these instructions in order to establish control for the re-establishment of lost corners (Tr. 16). He had to go to the north, east, and west boundaries (Tr. 16). It was also necessary for him to retrace a part of the north boundary to obtain control for re-establishment of other lost corners (Tr. 17). He recovered the northeast corner of the township, which was monumented with a marked stone, witnessed by bearing trees (Tr. 17). He also recovered the corner of Sections 5, 6, 31, and 32 on the north boundary (Tr. 18). While resurveying the true north boundary, as controlled by these two recovered corners, he recovered the corner of Sections 4, 5, 32, and 33, which was monumented with a marked basalt stone (Tr. 18).

Brooks went on to tell of his meeting with the Kaser brothers who told him the general location of the southwest and southeast corners of Section 16 (Tr. 19). Using this information, he located the original corner monuments which were marked with basalt stones which matched the ones in the original record (Tr. 20-22). He described the mound of stones

at the southeast corner of Section 16 as "circular in shape and made up of several stones fairly large in diameter, a cross section, and it had settled into the earth--I suppose this would be due to frost action over the years--until it was nearly buried. And you had to remove stuff away from this to determine that there was a mound rather than just a hump in the ground" (Tr. 21). This corner is near a fence corner from which a fence, partly fallen down, extends along the south boundary of Section 16 (Tr. 23). The monument found at the southwest corner of Section 16 "is a basalt stone matching the size of [the one in] the record \* \* \*. This stone however was still upright in the mound rather than having been turned over on the side" (Tr. 21).

Brooks found the northeast corner of Section 16, monumented with a basalt stone, faintly marked or unmarked, and a mound of stone, located in a fence line extending North and South (Tr. 23). The northwest corner of Section 16 "had been taken out by logging operations" (Tr. 23, 24). Fences extended to the East and South; by sighting along these fence lines Brooks determined where the fence corner had been and so determined the position of the section corner (Tr. 23).



The corners of Section 16 gave Brooks the control for the restoration of corners in the interior of the township that he was unable to locate on the ground (Tr. 24). Brooks then explained what he meant by control (Tr. 24, 25):

"\* \* \* [The corner of Sections] 16, 17, 20 and 21 for example, which would in effect control the line between that particular corner and the corner on the South boundary three miles to the South of it, or it would be the corner of Sections [32] and [33] on the South boundary. It would control the North-South position of all the intermediate corners. It would not control the East-West position of any of those corners. They would be controlled from the corner on the West boundary and a corner on the East boundary and a corner on the East boundary for East-West position." In Section 365 of the Manual of Surveying Instructions (1947), which was made a part of Brooks' special instructions, (Ex. 7, p. 2), the following statement is made: "The double proportionate measurement is the best example of the principle that existent or known corners to the north and to the south should control any intermediate latitudinal position, and that corners east and west should control the position in longitude"; and Section 350 of the Manual of Surveying Instructions

(1947) describes an "existent" corner as "one whose position can be identified by verifying the evidence of the monument, or its accessories, by reference to the description that is contained in the field notes, or where the point can be located by an acceptable supplemental survey record, some physical evidence, or testimony." Thus, Brooks is describing a procedure that follows the instructions in the Manual.

The corners Brooks found in Section 16 tied in well with the original field notes. "On the North boundary of Section 16, on the line directions between 9 and 16, Mr. Kincaid indicated the crossing in the Cherry Creek crossing or Cherry Creek Gulch \* \* \*. This crossing fits in very well with the corners as located \* \* \*" (Tr. 25-26). The measurements were very nearly the same as those indicated by Kincaid's field notes (Tr. 26). Archie Hamilton, who was apparently employed by the Hudspeths, assisted Brooks in 1959 in locating two corners on the ground: the corner of Sections 13, 24, 18, and 19, on the east boundary of the township, and the corner of Sections 33, 34, 3, and 4, on the south boundary of the township (Tr. 29-30).



Brooks completed his survey "\* \* \*" on the basis of my field notes, my notes that I kept actually in the field for distances between my temporary corners and the bearing between them, using these corners around 16 and any other corners that I had found, original corners, by calculation I computed the positions of all the corners that were missing and then made moves accordingly from my temporary points to these positions" (Tr. 27). Irving Zirpel, Jr., now Chief of the Branch of Cadastral Engineering, Bureau of Land Management, for the States of Oregon and Washington, reviewed and checked Brooks' work (Tr. 29, 87).

## APPENDIX B

### Statutes and Regulations

#### Rule 52(a), F.R.Civ.P.:

(a) Effect. In all actions tried upon the facts without a jury or with an advisory jury, the court shall find the facts specially and state separately its conclusions of law thereon, \* \* \*.

#### 43 U.S.C. sec. 2:

The Secretary of the Interior or such officer as he may designate shall perform all executive duties appertaining to the surveying and sale of the public lands of the United States, or in anywise respecting such public lands, and, also, such as relate to private claims of land, and the issuing of patents for all grants of land under the authority of the Government.

#### 43 U.S.C. sec. 751:

The public lands shall be divided by north and south lines run according to the true meridian, and by others crossing them at right angles, so as to form townships of six miles square, unless where the line of an Indian reservation, or of tracts of land surveyed or patented prior to May 18, 1796, or the course of navigable rivers, may render this impracticable; and in that case this rule must be departed from no further than such particular circumstances require.

Second. The corners of the townships must be marked with progressive numbers from the beginning; each distance of a mile between such corners must be also distinctly marked with marks different from those of the corners.



Third. The township shall be subdivided into sections, containing, as nearly as may be, six hundred and forty acres each, by running parallel lines through the same from east to west and from south to north at the distance of one mile from each other, and marking corners at the distance of each half mile. The sections shall be numbered, respectively, beginning with the number one in the northeast section and proceeding west and east alternately through the township with progressive numbers, until the thirty-six be completed.

Fourth. The deputy surveyors, respectively, shall cause to be marked on a tree near each corner established in the manner described, and within the section, the number of such section, and over it the number of the township within which such section may be; and the deputy surveyors shall carefully note, in their respective field books, the names of the corner trees marked and the numbers so made.

Fifth. Where the exterior lines of the townships which may be subdivided into sections or half-sections exceed, or do not extend six miles, the excess or deficiency shall be specially noted, and added to or deducted from the western and northern ranges of sections or half-sections in such township, according as the error may be in running the lines from east to west, or from north to south; the sections and half-sections bounded on the northern and western lines of such townships shall be sold as containing only the quantity expressed in the returns and plats respectively, and all others as containing the complete legal quantity.

Sixth. All lines shall be plainly marked upon trees, and measured with chains, containing two perches of sixteen and one-half feet each, subdivided into twenty-five equal links; and the chain shall be adjusted to a standard to be kept for that purpose.

Seventh. Every surveyor shall note in his field book the true situations of all mines, salt licks, salt springs, and mill-seats which come to his knowledge; all watercourses over which the line he runs may pass; and also the quality of the lands.

Eighth. These field books shall be returned to the Secretary of the Interior or such officer as he may designate, who shall cause therefrom a description of the whole lands surveyed to be made out and transmitted to the officers who may superintend the sales. He shall also cause a fair plat to be made of the townships and fractional parts of townships contained in the lands, describing the subdivisions thereof, and the marks of the corners. This plat shall be recorded in books to be kept for that purpose; and a copy thereof shall be kept open at the office of the Secretary of the Interior or of such agency as he may designate for public information, and other copies shall be sent to the places of the sale, and to the Bureau of Land Management.

43 U.S.C. sec. 752:

The boundaries and contents of the several sections, half-sections, and quarter-sections of the public lands shall be ascertained in conformity with the following principles:



First. All the corners marked in the surveys, returned by the Secretary of the Interior or such agency as he may designate, shall be established as the proper corners of sections, or subdivisions of sections, which they were intended to designate; and the corners of half- and quarter-sections, not marked on the surveys, shall be placed as nearly as possible equidistant from two corners which stand on the same line.

Second. The boundary lines, actually run and marked in the surveys returned by the Secretary of the Interior or such agency as he may designate, shall be established as the proper boundary lines of the sections, or subdivisions, for which they were intended, and the length of such lines, as returned, shall be held and considered as the true length thereof. And the boundary lines which have not been actually run and marked shall be ascertained, by running straight lines from the established corners to the opposite corresponding corners; but in those portions of the fractional townships where no such opposite corresponding corners have been or can be fixed, the boundary lines shall be ascertained by running from the established corners due north and south or east and west lines, as the case may be, to the watercourse, Indian boundary line, or other external boundary of such fractional township.

Third. Each section or subdivision of section, the contents whereof have been returned by the Secretary of the Interior or such agency as he may designate, shall be held and considered as containing the exact quantity expressed in such return; and the half sections and quarter

sections, the contents whereof shall not have been thus returned, shall be held and considered as containing the one-half or the one-fourth part, respectively, of the returned contents of the section of which they may make part.

43 U.S.C. sec. 772:

The Secretary of the Interior may, as of March 3, 1909, in his discretion cause to be made, as he may deem wise under the rectangular system on that date provided by law, such resurveys or retracements of the surveys of public lands as, after full investigation, he may deem essential to properly mark the boundaries of the public lands remaining undisposed of: Provided, That no such resurvey or retracement shall be so executed as to impair the bona fide rights or claims of any claimant, entryman, or owner of lands affected by such resurvey or retracement: Provided further, That not to exceed 20 per cent of the total annual appropriation for surveys and resurveys of the public lands shall be used for the resurveys and retracements authorized hereby.

43 U.S.C. sec. 773:

Upon the application of the owners of three-fourths of the privately owned lands in any township covered by public-land surveys, more than 50 per centum of the area of which townships is privately owned, accompanied by a deposit with the Secretary of the Interior, or such officer as he may designate, of the proportionate estimated cost, inclusive of the necessary work, of the resurvey or retracement of all the privately owned lands in said township, the Secretary, or



such officer as he may designate, shall be authorized in his discretion to cause to be made a resurvey or retracement of the lines of said township and to set permanent corners and monuments in accordance with the laws and regulations governing surveys and resurveys of public lands. The sum so deposited shall be held by the Secretary of the Interior or such officer as he may designate, and may be expended in payment of the cost of such survey, including field and office work, and any excess over the cost of such survey and the expenses incident thereto shall be repaid pro rata to the persons making said deposits or their legal representatives. The proportionate cost of the field and office work for the resurvey or retracement of any public lands in such township shall be paid from the current appropriation for the survey and resurvey of public lands, in addition to the portion of such appropriation otherwise allowed by law for resurveys and retracements. Similar resurveys and retracements may be made on the application, accompanied by the requisite deposit, of any court of competent jurisdiction, the returns of such resurvey or retracement to be submitted to the court. The Secretary of the Interior is authorized to make all necessary rules and regulations to carry this section into full force and effect.

43 U.S.C. sec. 1201:

The Secretary of the Interior, or such officer as he may designate, is authorized to enforce and carry into execution, by appropriate regulations, every part of the provisions of this title not otherwise specially provided for.

43 C.F.R. sec. 1842.2:

Subpart 1842--Appeals to the Director of  
the Bureau of Land Management

§ 1842.2 Who may appeal.

Except as otherwise provided in Subpart 2411 of this chapter, any party to a case who is adversely affected by a decision of an officer of the Bureau of Land Management other than the Director or person signing for the Director, shall have a right of appeal to the Director.

43 C.F.R. sec. 1843.5:

Subpart 1843--Actions by Director

§1843.5 Request for hearings on appeals  
involving questions of fact.

Either an appellant or an adverse party may, if he desires a hearing to present evidence on an issue of fact, request that the case be assigned to a Field Commissioner of the Bureau of Land Management for such a hearing. Such a request must be made in writing and filed with the Director within 30 days after answer is due and a copy of the request should be served on the opposing party in the case. The allowance of a request for hearing is within the discretion of the Director, and the Director may, on his own motion, refer any case to a Field Commissioner for a hearing on an issue of fact. If a hearing is ordered, the Director will specify the issues upon which the hearing is to be held.



43 C.F.R. sec. 1844.1:

Subpart 1844-Appeals to Secretary of the Interior

§ 1844.1 Right of appeal to the Secretary of the Interior.

Any party adversely affected may appeal to the Secretary of the Interior from a final decision of the Director, whether such final decision is on an appeal or is an original decision, except from such a decision which, prior to promulgation, has been approved by the Secretary. No appeal, however, may be taken from a decision of the Director affirming a decision of a subordinate official of the Bureau in any case where the party adversely affected shall have failed to appeal from the decision of such official.

43 C.F.R. sec. 9180.0-2(b)

Subpart 9180--Cadastral Surveys; General

(b) Resurveys. The real interest of the Government in the resurvey of the public lands is well stated in the said act of March 3, 1909, "to properly mark the boundaries of the public lands remaining undisposed of." Its duty being thus defined, the Bureau of Land Management will refrain from attempting to do more in the relocation of the corners of privately owned lands in a township being resurveyed than to re-establish such corners from the best available evidence of the original survey.

43 C.F.R. sec. 9180.0-3(a)(1)(2):

§ 9180.0-3 Authority.

(a) Delegation to Director, Bureau of Land Management. (1) In the establishment of the Bureau of Land Management by Reorganization Plan No. 3 of 1946, the office of Supervisor of Surveys was abolished and the functions and powers thereof were transferred to the Secretary of the Interior, to be performed by such officers or agencies of the Department as might be designated by the Secretary. Under that authority, the functions and powers formerly exercised by the Supervisor of Surveys were delegated to the Chief Cadastral Engineer, subject to the supervision of the Director, Bureau of Land Management. In the general reorganization and realignment of functions of the Bureau, the office of Chief Cadastral Engineer has been abolished, and the functions of that office have been delegated to the Director.

(2) By this sequence, the cadastral surveying work of the Bureau of Land Management has been placed under the immediate jurisdiction of the Director, subject to the direction and control of the Secretary of the Interior. Certain functions relating to specific phases of the cadastral surveying work have been delegated to the State Director.

43 C.F.R. sec. 9185.3-9185.4-3:

§9185.3 Requirements for resurveys; without cost to applicant.

§9185.3-1 Eligibility.

(a) Determined by ownership of land. As a general rule, and in the absence of any particular governmental purpose to be subserved,



no township is eligible for resurvey unless title to at least 50 percent of the area of the lands embraced therein remains in the United States. For the purpose of determining the eligibility of a township under this rule, lands covered by approved selections, school sections, and entries upon which final certificates or patents have been issued are to be considered as alienated lands. Townships within the primary limits of railroad land grants are generally ineligible.

(b) Determined by physical character of remaining public land. In general no resurvey will be undertaken unless the preliminary examination of the township develops evidence of existing settlement and agricultural possibilities sufficient to support the presumption that the unappropriated lands therein are such as to attract bona fide entrymen, thus eliminating townships which, although theoretically eligible, are of such a physical character that the resurvey thereof would serve no useful purpose.

(c) Small areas. In the application of the terms of the act of March 3, 1909 (35 Stat. 845), as amended, is not intended that there shall be undertaken any work involving the mere reestablishment of lost or obliterated or misplaced corners in a limited area of a township, such work being within the province of the local surveyors, and the authority of the public survey office will be limited to the giving of advice in accordance with the circular for the restoration of lost or obliterated corners. Employees of the Bureau of Land Management are prohibited from participating in the resurvey of a township, the reestablishment of lost corners, or in the subdivision of sections for private parties, even if the expense is borne by the county or municipal authorities or by individuals.

§9185.3-2 Showing required.

(a) Necessity. The applicants for the resurvey of any township are required to present satisfactory prima facie evidence of the necessity for such action, based either upon general obliteration of evidences of the original survey or upon conditions so grossly defective as to preclude the possibility of a reasonably certain identification of the subdivisions of the subsisting survey or a satisfactory local restoration thereof.

(b) Condition of original survey. Applications for the resurvey of each township must be supported by evidence in the form of a statement, preferably from the county or other competent surveyor, showing in detail that the evidences of the original survey have been obliterated to such an extent as to make it impracticable to apply the suggestions of the circular issued by the Bureau of Land Management for the necessary restoration of the lines and corners in the proper identification of the legal subdivisions occupied by the present or prospective entrymen or that the obliteration of the original monuments has become so advanced that the land boundaries can be identified only through extensive retracements by experienced engineers of the Bureau of Land Management.

§9185.3-3 Majority of land owners.

A majority of the settlers in each township are required to join in the application, and, in addition, there must appear the endorsements of the entrymen and owners, including the State, whose holdings represent the



major part of the area entered or patented, with a description opposite each name of the lands actually occupied, entered, or owned, and a statement as to whether the applicant is a settler, entryman, or owner thereof. Where an entryman or owner, including the State, has failed for any reason whatsoever to join in the application, evidence of service of notice upon him for at least 30 days in advance of the filing of the application is required in order that he may be afforded ample opportunity to make timely protest against the granting of such resurvey if in his opinion such action is undesirable.

**§9185.4 Requirements for resurvey; with cost prorated.**

**§9185.4-1 Estimate of cost.**

(a) The cost of resurvey procedure is as a rule considerably in excess of that incident to the execution of original surveys and may range between rather wide limits. Where the obliteration is not excessive and the evidences of the original survey are harmoniously related, extensive verifying retracements will be unnecessary and ordinary dependent methods of resurvey can usually be applied. If, however, the obliteration is general or total, many miles of preliminary retracement may be required in order to obtain technical control, and where, by reason of errors in the original survey, the existing evidences thereof are discordant and conflicting locations have resulted, the procedure required may, in the case of densely entered townships, involve an expense of \$5,000 or more per township.

(b) The applicants for resurvey should understand, therefore, that although the estimate supplied will be as nearly correct as the available information will permit, its accuracy cannot be guaranteed, and, consequently, all such estimates are subject to revision, if necessary, as the work proceeds and the field conditions are more fully developed. Any deposit in excess of actual cost will be returned to the applicants as provided by law, but in cases where the cost exceeds the deposit made in accordance with the estimate, an additional deposit will be required, failing which, operations will be suspended.

(c) In the application of the terms of this act it is not intended that there shall be undertaken any work involving the mere re-establishment of lost or obliterated or misplaced corners in a limited area of a township, such work being within the province of the local surveyor, and the authority of the State Director will be restricted to the giving of advice in accordance with the circular for the restoration of lost or obliterated corners. Employees of the Government are prohibited from participating in the resurvey of a township or the reestablishment of lost corners or in the subdivision of sections for private parties, even if the expense is borne by the county or State authorities or by individuals, except as such action is specifically authorized by the Director, Bureau of Land Management, in accordance with the provisions of existing statutes.

(d) Deposit required: The deposit required of the petitioners by law must accompany the application and must be made in the amount, at the place and in the manner prescribed by the instructions which will accompany the estimate.



§9185.4-2 Showing required.

(a) Necessity. The applicants for the resurvey of any township are required to present satisfactory prima facie evidence of the necessity for such action. In general, it must be shown that the evidences of the original survey are so widely obliterated or that the prevailing survey conditions are so grossly defective as to preclude the satisfactory identification of the subdivisions of the subsisting survey or that the evidences of the original survey are in such an advanced state of deterioration that action looking to their preservation and perpetuation is expedient as in the public interest.

(b) Ownership of land. The applicants for resurvey are required to preface their petition by the statement that the extent of privately owned lands within the township is in excess of 50 percent of the total area thereof. If necessary, information in this connection may be obtained by the petitioners from the manager of the land office having local jurisdiction. Failure to comply with the condition set forth in this section or material error in the showing made, will not only result in delaying action upon the petition, but may require its rejection if it is found that the township is not properly subject to resurvey under the terms of the governing act.

§9185.4-3 Three-fourths of land owners.

The owners of three-fourths of the privately owned lands within the township are required to join in the application, and all petitioners in whom ownership is vested, either individuals, the State, or corporations such as

railroad companies whose interests are involved, are further required to supply, following their respective signatures, an accurate description by legal subdivision, section, township, and range of the lands to which title is claimed. Moreover, it must appear that notice of the proposed resurvey has been served upon all owners who have for any reason failed to join in the petition, and, in addition, it is highly desirable that all record entrymen who, under the terms of the act are not required to become parties to the petition, be similarly informed to the end that their objections, if any, may be heard and subsequent protest based upon the plea of ignorance may, insofar as possible, be avoided.

#### PART 9230--TRESPASS

##### Subpart 9239--Kinds of Trespass

##### §9239.0-8 Measure of damage.

The rule of damages to be applied in cases of timber, coal, oil, and other trespass in accordance with the decision of the Supreme Court of the United States in the case of *Mason et al. v. United States* (260 U.S. 545, 67 L. ed. 396), will be the measure of damages prescribed by the laws of the State in which the trespass is committed, unless by Federal law a different rule is prescribed or authorized.



Ore. R.S. sec. 209.020:

Surveys on court order. The county surveyor shall execute all orders directed to him by any court of record or county court for surveying roads, or surveying or resurveying any tract of land the title to which is in dispute before such court, and all orders of survey for the partition of real estate.

Ore. R.S. sec. 209.070:

Duties in respect to surveys. \* \* \*

\* \* \* \* \*

(6) Make all surveys of legal subdivisions in conformity with the laws and regulations of the General Land Office of the United States.

Ore. R.S. sec. 209.200:

Resurvey of government-surveyed lands.  
In the resurvey of lands surveyed under the authority of the United States, the county surveyor shall observe the following rules:

(1) Section and quarter-section corners, and all other corners established by the government survey, must stand as the true corners.

(2) They must be re-established at the identical spot where the original corner was located by the government survey, when this can be determined.

(3) When this cannot be done, then such corners must be re-established according to the government field notes, adopting proportionate measurements where the present measurements differ from those given in the field notes.

IN THE UNITED STATES COURT OF APPEALS  
FOR THE NINTH CIRCUIT

Nos. 20905-10905

UNITED STATES OF AMERICA,

Appellant and Cross-Appellee

v.

JOHN HUDSPETH, ET AL.,

Appellees and Cross-Appellants

ADDENDUM TO THE BRIEF FOR THE UNITED STATES

In accordance with Rule 18(f) the following is a  
list of record references to the exhibits:

<u>Exhibit</u>	<u>Identified</u>	<u>Offered</u>	<u>Received</u>
United States' Exhibits			
1-4	11	11	11
5	--	34	35
6-8*	--	11	11
23-	--	92	92
23-A	97	--	--
24	--	92	92

\*/ These exhibits were reproduced and appear in a third  
volume of the record entitled "Exhibits."





<u>Exhibit</u>	<u>Identified</u>	<u>Offered</u>	<u>Received</u>
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Hudspeths' Exhibits

31	--	33	84
32	--	120	122
34	--	113	113
37	--	35	35



CERTIFICATE OF EXAMINATION OF RULES

I certify that, in connection with the preparation of the brief and this addendum, I have examined Rules 18 and 19 of the United States Court of Appeals for the Ninth Circuit, and that, in my opinion, the foregoing brief with addendum are in full compliance with those rules.

---

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### CERTIFICATE OF SERVICE

The brief in this case, as well as this addendum, has been served upon the following opposing counsel: Donald W. McEwen, Esquire, Oake, Jurgens, Frosty, Saylor and McEwen, 1408 Standard Bldg., 1100 S.W. Sixth Avenue, Portland, Oregon 97204; and James Y. Bodie, Esquire, Bodie and Minturn, 203 North Main Street, Prineville, Oregon 97754, by placing same in the United States mail, properly addressed, postage prepaid. In such manner the brief was served on September 7, 1966, and the addendum was served on this 23rd day of September, 1966.

---

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Attorney, Department of Justice,  
Washington, D. C. 20530.



**United States**  
**COURT OF APPEALS**  
**For the Ninth Circuit**

UNITED STATES OF AMERICA,  
*Appellant and Cross-Appellee,*  
v.

JOHN HUDSPETH, ET AL,  
*Appellees and Cross-Appellants.*

*On Appeal from the United States District Court  
for the District of Oregon*

**BRIEF FOR APPELLEES AND CROSS-APPELLANTS**

**FILED**

DEC 1 1966

WM. B. LUCK, CLERK

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FEB 14 1967





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UNITED STATES OF AMERICA,  
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---

*On Appeal from the United States District Court  
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---

**BRIEF FOR APPELLEES AND CROSS-APPELLANTS**

---

**REPLY TO APPELLANT'S BRIEF**

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**SUMMARY OF ARGUMENT**

This was a trespass action by the United States, based upon defendants' cutting of timber on lands claimed to be owned by the Government. The burden of proof is of course upon the Government. There is no dispute over the fact that timber was cut by defendants in the locations in question. The only question is whether the cutting was on the Government's

side of the boundary lines established in 1872 or on the defendants' side. As evidence of the location of that line, the Government relied solely on resurveys conducted by the Bureau of Land Management in 1959 and 1962, six and nine years after the last cutting. The critical question of fact, as posed by the pre-trial order, is whether these resurveys were accurate. The answer, as found by the lower court, is negative.

The Government's brief argues that defendants did not exhaust their administrative remedies to protest the 1959 and 1962 resurveys. However:

1. The pre-trial order contains no such contention and frames no such issue.

2. There was no evidence that administrative remedies were not exhausted.

3. The doctrine of exhaustion of administrative remedies is inapplicable where the Government, and not the citizen, initiates legal proceedings.

The Government's brief argues that the administrative decision, that is, the resurvey, was not shown to have been arbitrary or capricious. However:

1. The Pre-trial Order contains no such contention and frames no such issue. As aforesaid, the issue framed by the Pre-Trial Order was the *accuracy* of the resurvey.

2. Such a showing is unnecessary in this case. The statute giving the Department of Interior the authority to resurvey, 18 U.S.C. 722, expressly provides that

the resurvey may not impair bona fide existing rights. Since defendants' rights had vested long prior to the resurveys in question, the resurveys could not affect their rights, whether or not the department acted arbitrarily. If the resurveys in fact erred in favor of the Government, they operate to divest bona fide existing rights, irrespective of good faith, and so the Government's case must rest on a showing that the resurveys were in fact accurate.

The Government seems to argue that the resurvey must control if the resurveyor followed procedures set forth in the 1947 Department of Interior Manual of Surveying Instructions. However:

1. Nowhere in the Pre-tiral Order is there a contention that resurveys are conclusive if manual procedures are followed.

2. There was no evidence that the resurveyor actually followed manual procedures. The manual was not even introduced into evidence.

3. The governing statute also negates this argument. The resurvey cannot divest existing rights based on the original survey, and so the question must be whether the original lines were in fact accurately located by the resurvey. If in fact the resurvey does not accurately locate the original lines, the Government can gain nothing by the fact that the resurvey followed procedures set forth in the Department's Manual.

The Government argues that defendants were neg-



ligent in the procedures they employed to establish their lines before cutting. However, this contention, raised for the first time in the appellate brief, is irrelevant. The burden of proof is on the Government. If the Government establishes the location of the boundary lines contended by it, the defendants are trespassers; if the Government's proof in this respect fails, the defendants are not trespassers. In either case, the methods employed or not employed by the defendants are irrelevant.

The Government argues that compliance with the manual is evidence that the resurvey accurately located the lines of the original survey. However:

(1) There was no evidence of such compliance.

(2) There was evidence that the methods employed by the resurveyor, whatever their source, varied substantially from the methods employed by the original surveyor, and that this variance produced results on the ground substantially different from those of the original survey. The resurveyor admitted these differences in procedure, he admitted the differences in results, and, in response to a question from the court, he admitted that, despite his instructions to re-establish the lines of the original survey, he made the survey the way he thought it "*should* have been made" in the first place. The transcript makes it apparent that the procedures employed actually evidenced the *inaccuracy* of the resurveys.

(3) There was ample evidence, most of it from the Government's witnesses, that the resurveys in fact did *not* re-establish the original boundary lines. For example, there was evidence that the first corner marker found by the resurveyor, which he admitted was important to his findings, had actually been placed not by the original surveyor but by the landowners, some 60 years after the original survey. The resurveyor found very few markers, and there was evidence that most of these either were not markers at all or were markers placed in a private survey made in the 1930's.

The Government argues that the court's findings were insufficient. However, the issues were clear and it is plain from the findings that the court's oral ruling that the court found that the Government's case was based entirely on a survey which was not a true resurvey designed to locate the original lines, but was rather an *entirely new survey* based on new and different methods and made with the intent of placing the lines where they *should* have been placed, and not where they actually *were* placed. As such, the resurvey was not competent evidence of the location of the original lines, and the Government accordingly failed to prove its case.

## REPLY TO CONTENTION THAT DEFENDANTS FAILED TO EXHAUST ADMINISTRATIVE REMEDIES

1. There is no such contention or issue in the pre-trial order.

“We need not comment upon the impropriety of this court considering reversal of a District Court judgment for failure to pass upon an issue which was never framed for consideration by that court.” *First Federal Savings & Loan v. United States*, 295 F.2d 481 (9th Cir. 1961).

The pre-trial order herein, which was approved by the United States, purports to enumerate the contentions of the United States, the issue of fact and the issues of law. Nowhere in that order is this issue presented.

Rule 16 of the Federal Rules of Civil Procedure provides that the pre-trial order “controls the subsequent course of action unless modified at the trial to prevent manifest injustice.”

“One of the chief purposes of pre-trial procedure, and the principal usefulness of a pretrial order, is to formulate the issues to be litigated at the trial. The parties are bound by the pre-trial order. They may not later inject an issue not raised at the pre-trial conference. Otherwise the primary objective of pre-trial procedure would be defeated.” *McCarthy v. Lerner Stores Corporation*, 9 F.R.D. 31.

In *First Federal Savings & Loan v. United States*, supra, the appellant’s appeal brief argued that the



District Court erred in giving the Government specific performance of a lease for the reason that the promised consideration for the lease was inadequate. This court of appeals refused to consider this argument, stating:

“If the question of adequacy of consideration had been made an issue in this case we might possibly find it necessary to remand the cause to the district court with directions to make a finding upon the question of the adequacy of consideration. However, the case was tried after a pretrial conference and on entry of an order defining the issues to be tried and setting forth the contentions of the parties with respect to the facts and the law. The question of the adequacy of the consideration and the fairness of the contract was not listed as an issue in the pretrial order which undertook to set forth all of the issues of fact and of law to be tried and determined by the court.” 295 F.2d at 482.

**2. There was no evidence that administrative remedies were not exhausted.**

For all the record shows, defendants may have completely exhausted their administrative remedies.

**3. The doctrine of exhaustion of administrative remedies is inapplicable where the citizen does not seek affirmative relief, but only seeks to defend himself in proceedings initiated by the government.**

In all the cases cited by the Government (App. Br. 12, 16), the administrative agency was the *defendant*. This is no coincidence. The courts have point-



ed out that the doctrine of exhaustion of administrative remedies is inapplicable where the agency, not the citizen, goes to court for relief.

In *United States v. McCrillis*, 200 F.2d 884 (1st Cir. 1952), an action by the government to collect statutory damages for rental overcharges, the court rejected the Government's contention that the defendant landlord could not question the Government's determination of a maximum rent because he had failed to invoke available administrative procedures to set aside the order establishing the maximum rent:

"It was pointed out in *Smith v. United States*, *supra*, that the discretionary rule adopted by courts of equity to the effect that a petitioner will be denied equitable relief where he has failed to pursue an administrative remedy under which he might obtain the same relief, is wholly misapplied when invoked against a landlord who is not seeking equitable relief but is merely defending himself against an enforcement action. We distinguished cases where the landlord was a petitioner seeking equitable relief by way of an injunction or declaratory judgment." 200 F.2d at 885.

See also *Smith v. United States*, 199 F.2d 377, 381 (1st Cir. 1952), *United States v. Fritz Properties*, 89 F. Supp. 772, 77 (D.C. N.D. Cal. 1950), *Wood v. Laabs*, 92 F. Supp. 220 (D.C. W.D. Mich. 1950).

**REPLY TO CONTENTION THAT ADMINISTRATIVE  
DECISION IS NOT SHOWN TO BE ARBITRARY  
OR CAPRICIOUS**

**1. There is no such contention or issue in the pre-trial order.**

As pointed out previously, the pre-trial order “controls the subsequent course of action,” Rule 16, Federal Rules of Civil Procedure, and issues not framed by the pre-trial order cannot be raised for the first time in the appellate court. The pre-trial order herein framed the issue of fact as to the survey as follows: “Did plaintiff *accurately* resurvey Township 11 South, Range 19 East, Willamette Meridian, Oregon, in accordance with the original surveys?” (Pre-trial Order, page 4, emphasis added).

In accordance with the pre-trial order, the case was tried and determined on the issue of the *accuracy* of the Government’s resurveys, and not on the issue of arbitrariness or capriciousness.

**2. The governing statute here makes it unnecessary to show that the administrative action was arbitrary or capricious.**

43 U.S.C. 772 provides as follows:

“The Secretary of the Interior may, as of March 3, 1909, in his discretion cause to be made, as he may deem wise under the rectangular system on that date provided by law, such resurveys or retracements of the surveys of public lands as, after full investigation, he may deem essential

to properly mark the boundaries of the public lands remaining undisposed of: Provided, *that no such resurvey or retracement shall be so executed as to impair the bona fide rights or claims of any claimant, entryman, or owner of lands affected by such resurvey or retracement: . . .*" [Emphasis added].

The emphasized proviso makes inapplicable any argument that the Government's action must be shown to be arbitrary or capricious. The controlling statute does not vest in the secretary any discretion to divest prior rights. If in fact a resurvey divests prior rights, it is invalid, whether the surveyor acted arbitrarily or in good faith.

Prior to the time of the resurveys relied on by the Government, the defendants herein owned or had cutting rights in the lands adjoining the Government lands claimed to have been trespassed upon, and in fact the cutting now alleged to have been a trespass took place prior to these resurveys (Agreed Fact No. 3, Pre-Trial Order, p. 2). Accordingly, defendants' rights had vested at the time of the resurvey, and the basis of their rights was the original survey of 1872. To the extent that the resurveys purport to deny them cutting rights established by the original surveys, the resurveys impair their bona fide rights and are invalid, irrespective of the nature of the conduct of the surveyor or other officials involved. The question must be that framed by the pre-trial order: Was the resurvey accurate? Did the resurveyor in fact reconstruct the original survey?



This contention is supported by the courts:

The purpose and effect of a Government resurvey is well summarized in the recent opinion of *Trustees of Internal Improvement v. Toffel*, 145 So. 2d 737 (Fla. 1962) :

“A corrected survey or resurvey can be used instead of an original survey until such time as rights have been acquired to a specific tract of land under the original survey. However, the original actual survey of public lands of the federal government on the faith of which rights have been acquired controls as against a survey subsequently made by the government affecting those rights.

“In making a resurvey, the question is, not where would an entirely accurate survey locate the lines, but where did the original survey locate the lines. In all cases, the original survey, wherever possible, must be retraced, since it cannot be disregarded or needlessly altered after property rights have been acquired in reliance upon it. The purpose of a resurvey is to furnish proof of the location of the lost lines or monuments, and not to dispute the correctness of the original survey or to control it.” 145 So. 2d at 741-2.

The Supreme Court of the United States has made similar statements. See *Grand Rapids and Indiana Railroad Company v. Butler*, 159 U.S. 87, 94 (1895); *Keene v. Calumet Canal Company*, 190 U.S. 452, 461 (1902).

The reason for the rule that the Government's re-



surveys cannot affect vested rights is well stated by the United States Supreme Court in *Hardin v. Jordan*, 140 U.S. 371, 401 (1890) as follows:

“If this were not so, the titles derived from the United States, instead of being the safe and assured evidences of ownership which they are generally supposed to be, would be always subject to the fluctuating, and in many cases unreliable, action of the land office. No man could buy of the grantee with safety, because he could only convey subject to the right of the officers of the government to annul his title.”

None of the cases cited by the Government involves a resurvey.

It would seem clearly unconstitutional for Congress to provide that a survey by a government agency may divest property rights without compensation, provided only that the agency acts in good faith. The question must be: Did the resurvey accurately retrace the lines of the original survey?

**REPLY TO CONTENTION THAT DEPENDENT RESURVEYS  
MUST BE ACCEPTED AS HAVING RE-ESTABLISHED  
ORIGINAL BOUNDARIES WHEN CONDUCTED IN  
ACCORDANCE WITH THE MANUAL OF  
SURVEYING INSTRUCTIONS**

**1. There is no such contention or issue in the pre-trial order.**

In accordance with the pre-trial order, as quoted previously, this case was tried and determined upon an inquiry into the surveyor's accuracy, not his con-

formity to the 1947 Manual of Surveying Instructions. The Government cannot now contend that the survey is binding, irrespective of its accuracy, if the surveyor followed Manual procedures.

The extent of this departure from the case as tried is indicated by the fact that although the Government's brief places great emphasis on the surveyor's supposed compliance with the Manual, the Manual was never introduced into evidence and there is no express reference to it in the transcript of testimony. The only witness who could testify that Manual procedures were followed was Floyd A. Brooks, the resurveyor. Brooks identified his instructions, which refer to the Manual (Tr. 10-12; Ex. 7, 8), but the writer can find no testimony by Brooks that he actually *followed* the procedures of the Manual in the field.

**2. Under the governing statute, conformity to the manual is no substitute for accuracy.**

As aforesaid, the statute governing resurveys contains the following provision:

“. . . no such resurvey or retracement shall be so executed as to impair the bona fide rights or claims of any claimant, entryman, or owner of lands affected by such resurvey. . . .” 43 U.S.C. 772.

It has been pointed out previously herein (see page 10) that defendants' rights had vested at the time of the resurveys, and that the resurveys, if inaccurate in the Government's favor, would divest defendants' bona fide rights in violation of the stat-

ute. Compliance with the Department's Manual cannot excuse a direct violation of the mandate of the statute. The question must be that framed by the pre-trial order herein: Were the resurveys accurate?

None of the cases cited by the Government involves a resurvey under this statute.

**REPLY TO CONTENTION THAT DEFENDANTS WERE  
NEGLIGENT IN NOT FOLLOWING APPROPRIATE  
METHODS FOR DETERMINING  
THEIR BOUNDARIES**

**There is no such contention or issue in the pre-trial order, and such a contention is immaterial.**

Defendants must again note that the sole factual issue framed by the pre-trial order as to the boundaries was whether the Government's resurveys were accurate. This is properly the issue.

It is incumbent upon the Government to prove that the defendants were cutting on government land. If they were, they were trespassers; if they were not, the Government has no complaint. It is wholly irrelevant to consider whether the defendants were negligent in determining the location of their boundaries, or whether they acted in good faith, or what methods they did or did not employ, or even whether they made any effort at all to locate their boundaries. The question is where the boundaries were, and the Government has the burden of proof here.



**REPLY TO CONTENTION THAT THE ACCURACY OF THE  
RESURVEYS IS PROVEN BY PROOF THAT THE  
RESURVEYS WERE CONDUCTED IN  
ACCORDANCE WITH THE MANUAL**

The Government in this portion of its argument (App. Br. 22-28) apparently recognizes that the controlling question must be the accuracy of the resurveys, and now argues that such accuracy is proven by evidence that the resurveyor followed the procedures set forth in the Manual of Surveying Instructions (United States Department of the Interior, 1947).

**1. There is no evidence that the surveyor followed the procedures of the manual.**

As aforesaid, the Manual was not introduced into evidence and the writer can find no direct testimony that the field work actually followed the procedures set forth in the Manual. However, as will appear, this point is not highly significant.

**2. Evidence of compliance with 1947 Manual does not prove accurate retracement of 1872 survey.**

It would seem apparent that evidence that the resurveyor followed the procedures of the 1947 Manual could be relevant as evidence of conformity to the original survey only if it were established that the original surveyor followed identical procedures. For example, if the techniques of alignment and measurement set forth in the 1947 manual are different from those employed by the 1872 surveyor, it is likely that



the resurveyor's footsteps would not be those of the original surveyor.

This is particularly important in this case, where the surveyor purported to find very few markers, and based his findings largely on his calculations as to where he thought the controlling monuments should have been. The 1947 Manual was not in evidence, and there is nothing in the record from which it can be deduced that it prescribed procedures similar to those followed 65 years earlier.

To the contrary, the testimony of the Government's own witnesses produced overwhelming evidence that the methods employed by Brooks in his resurvey were substantially *different* from those employed by Kincaid, the original surveyor, and that these differences produced substantially different results on the ground:

(1) The Government's Cadastral Surveyor for the Portland office of the Bureau of Land Management expressly testified that Kincaid's methods and instrumentation were different from the resurveyor's (Tr. 100), and testified that it was a common experience in the Northwest to find that old surveys weren't "up to par," and "they didn't do it maybe to regulation" (Tr. 90).

"Our—maybe our methods now are a little bit better and we determine these a little closer. Maybe in the future they'll have them closer, and they'll say that our work is way off as far as distance goes." (Tr. 98)

(2) The Government's witness Brooks, the re-surveyor, expressly admitted that the variance between his figures and Kincaid's suggested to him that different methods were employed by the two men:

“THE COURT: Well, wasn't that of some significance to you in the survey, that yours [boundary measurements] did not coincide with the original surveys?

THE WITNESS: Well, sir —

THE COURT: Wasn't that what you were attempting to do?

THE WITNESS: To establish the original survey.

THE COURT: Yes.

THE WITNESS: Right. Quite often in re-tracing these original surveys, we find this type of discrepancy.

THE COURT: Well, that may be true, but wasn't it of some significance to you that there was that difference in re-establishing your own lines?

THE WITNESS: Yes.

THE COURT: That *one survey may have been made on one theory and the other made on another theory?*

THE WITNESS: Yes.

THE COURT: Now, your survey was made on the way that you thought the survey *should have been made?*

THE WITNESS: This is correct.” [Emphasis added] (Tr. 44).

Specifically, Brooks testified as to variances between his and Kincaid's methods of measuring dis-

tances on slopes (Tr. 37, 62), he testified that he "closed his lines" while Kincaid did not (Tr. 37, 39, 40), he and his supervisor testified that Kincaid used a different method for determining bearings (Tr. 64, 104).

Brooks testified that Kincaid's methods produced "distortions" from Brooks' findings (Tr. 64) and that Brooks' bearings and distances proved different from Kincaid's (Tr. 60, 61).

The results of the above discrepancies were hardly trivial: Brooks found the South boundary of the township to be 283 feet shorter than Kincaid found it (Tr. 41-42), he admitted that his center point of the South boundary might be 385 feet off Kincaid's (Tr. 42-43), and he admitted substantially different findings as to the length of the North and West boundaries of the township (Tr. 43-44). Brooks' supervisor, Irving Zirpel, Jr., testified that in particular cases Kincaid's notes showed distances of 40 and 80 chains while Brooks' resurvey indicated distances of 36 and 72-79 chains respectively (Tr. 99).

The foregoing demonstrates that the Government cannot prove that its resurvey accurately re-established the original survey by showing that the resurvey followed the 1947 Manual procedures. To the contrary, the evidence of the many and significant differences between the methods and results of the original surveyor and those of the resurveyor compel the conclusion that by following the 1947 procedures in this case the resurveyor *insured* departure from the footsteps of the 1872 surveyor.



Although the Government's present methods may be better than those employed by Kincaid, and although Kincaid might have done a better job, the point remains that, as recognized by the Government's brief, *the original monuments control the rights of the parties*, irrespective of where they *should* have been located, and, where monuments can be located only by calculation, the resurveyor must calculate as the original surveyor did, irrespective of the inferiority or inaccuracy of the original surveyor's methods. For example, in this case, where the original surveyor measured distances by slope measurement, the resurveyor should have done the same, instead of using horizontal measurements. As the court developed in examining Brooks, the variances between his results and Kincaid's demonstrated to him the difference in methods used, but Brooks persisted in making the survey as the original "should have been made."

**3. There was ample evidence that the resurvey was inaccurate.**

As set forth above, the resurveyor employed different methods of calculation than those employed by the original surveyor, and admitted substantially different results. Beside the variance which necessarily followed the different methods employed by Brooks, there was evidence that even the few markers found and relied on by him may not have been those of the original survey:

(1) Brooks testified that in his opinion the original surveyor set the stone which was the first marker



found by Brooks and which he assumed to mark the Southeast corner of Section 33 (Tr. 40, 48), and that “to a certain extent” Brooks’ location of that corner would control *the rest of his work throughout the township* (Tr. 40). However, he admitted that the corner stone found by him was not marked as it should have been if it had actually been placed in 1872 by Kincaid to mark that particular corner (Tr. 51). The defendants’ witness, Gail Thomas, a licensed surveyor, testified that in the course of his investigation he interviewed the former landowner’s brother, who told him that the corner stone in question was placed only 30 to 35 years ago by himself and his brother, following a survey made by a man named Peck (Tr. 108, 141). This is supported by the testimony of Thomas Stephenson, a long-time resident of the area (Tr. 153), and by the fact that Brooks found at this point a marked witness tree which was not referred to in the original survey notes (Tr. 52), and Thomas found that tree to be only 70 years old and the surveyor’s markings to be only 30 to 35 years old (Tr. 107, 126-127, Def. Exs. 36A, 36B). Thomas also testified that the methods used by Kincaid, as testified to by the Government’s witnesses, would have produced a corner location about 700 to 800 feet to the east of the point relied on by Brooks (Tr. 110-111).

(2) Thomas directly controverted Brooks’ location of the Southwest corner of Section 34 (Tr. 128-130), his location of the Southeast corner of Section 27, which discrepancy Thomas explained to have re-

sulted from the admitted difference between Brooks' and Kincaid's methods of slope measurement (Tr. 130), he controverted Brooks' location of the Southeast corner of Section 5, which was not marked as it should have been if it had been placed by Kincaid (Tr. 131). Thomas also pointed out that Kincaid's method of slope measurement would have placed that last corner further to the East than the rock found by Brooks (Tr. 131-2). Thomas controverted the location of corner markers purportedly found by Brooks in Section 36 ("a mismarked stone," Tr. 132), Section 13 ("a mismarked stone, . . . he overlooked six marks on the other side of the stone . . .," Tr. 133), and Section 16 ("these were unmarked basalt stones . . . there aren't enough trains in the world to haul all the rocks away in that area. They are in every size and every description, . . . So the possibility of finding two rocks of the same size are very — well, the possibility is good." (Tr. 134-135).

Thomas testified as to and explained substantial variances between the results of the Brooks resurvey and the original survey, summarized in his statements that the township as measured by Brooks was longer than as measured by Kincaid (Tr. 117), that there was "a great disparity" between the bearings of Kincaid and those of Brooks (Tr. 125), and that the area of the alleged trespass had been materially changed by the Brooks resurvey (Tr. 120-121).

From all the foregoing, it seems reasonable to conclude that many of the corner markers relied on

by Brooks were established by the Peck survey of the 1930's. Brooks himself testified that in his opinion Kincaid did not establish all the corners in the interior of the township (Tr. 45) and Thomas agreed, stating that such placement, which would have required Kincaid to travel and survey 119 miles and place 120 monuments in five days, was "impossible" (Tr. 137).

Furthermore, on cross-examination by the court, Brooks admitted that the methods used by the defendants in determining the areas which they might log could have accurately established the original survey lines, and that in that event there would have been no trespass (Tr. 167-168).

## **REPLY TO CONTENTION THAT FINDINGS ARE DEFICIENT**

### **1. Findings are sufficient if the lower court's ruling is understandable.**

The rule in this circuit, as elsewhere, is that the lower court's failure to make specific findings does not require a remand if a complete understanding of the issues may be had by the court of appeals without the aid of separate findings. *Graham v. United States*, 243 F.2d 919 (9th Cir. 1957). See also *Westley v. Southern Railway*, 250 F.2d 188 (4th Cir. 1957). Any defects will be waived where the error is not substantial. *Rossiter v. Vogel*, 148 F.2d 292 (2nd Cir. 1945).



## 2. The ruling here is clearly understandable.

The factual issues presented by the pre-trial order were simple:

“(1) Did plaintiff accurately re-survey Township 11 South, Range 19 East, Willamette Meridian, Oregon, in accordance with the original survey?”

(2) If issue No. 1 is answered in the affirmative, what value of timber did defendants cut and remove from lands of the plaintiff?” Pre-trial Order, page 4.

The Government based its case, as it must, on the original 1872 Kincaid survey:

“The simple fact is that the suit was instituted ‘based on the Kincaid survey.’ ” (App. Br. 23).

As recognized by the Government, the resurveys had no significance other than as evidence of the location of the lines of the Kincaid survey:

“Thus, a dependent re-survey performed in accordance with the manual does not affect or change prior existing rights in the land. It establishes what those rights always have been” (App. Br. 26).

From the direct examination of the resurveyor:

“Q. Is it correct then that *you were attempting to in effect follow the steps of the original surveyor* and determine where he placed the lines originally?

A. This would be true.” [Emphasis added] (Tr. 12).



The court made it absolutely clear that it found that Brooks did *not* actually retrace the original survey:

“MR. BORGESON: Well, as I understand, he claims that he has retraced the footsteps of the original survey —

THE COURT: Well, as a matter of fact, he hasn't. No matter what he says, if the original surveyor was ever out there on the ground, this isn't what the original surveyor went through.” (Tr. 65-66).

“On the plaintiff's contentions, I find that the Government has failed to prove plaintiff's Contentions 1, 2, and 3, and therefore, my findings are in favor of the defendant.” (Tr. 174).

The latter were all the Government's contentions (see Pre-Trial Order, pp. 3-4).

The Government argues that the lower court did not understand that the function of a dependent resurvey is to re-establish the lines of the original survey. This argument insults the court's intelligence. The function of the resurvey was plainly explained by the resurveyor Brooks at the onset of the Government's case (Tr. 12). The significance of discrepancies between the original survey and the Brooks resurvey permeates all the examinations by counsel. The court's own examination of Brooks, particularly the questioning at Tr. 64-65, makes it plain that the court recognized the obvious function of the resurvey, and that the court found, as it plainly stated at Tr. 65-66, that the resurveyor did not discharge that function, that is, he did not retrace the original lines.

Brooks in fact did not really *attempt* to locate the actual original lines, and the court recognized this. The court asked Brooks if it was not the fact that “your survey was made in the way that you thought the survey *should* have been made?”, and Brooks answered in the affirmative (Tr. 44). The court stated that “in fact, what you (Brooks) are saying is that you made a new survey; isn’t that true?” (Tr. 64). The court’s preservation of the Government’s right to a retrial “based on the Kincaid survey” is not evidence of the court’s misunderstanding of the function of a dependent resurvey, as the Government contends, but is consistent with the court’s view that Brooks’ survey was not evidence of the location of Kincaid’s lines, but was instead “a new survey” made in the way Brooks thought the original survey “should have been made.” The court’s statement that there was “a failure of proof” (Tr. 175) is also consistent with its view that Brooks’ survey was not evidence of the lines of the original survey. The testimony as to damages was based entirely on the Brooks survey (Tr. 84), and the court obviously felt that the Government was entitled to a chance to prove its damages based upon evidence of the Kincaid survey.

### CONCLUSION

Findings of fact are not set aside unless clearly erroneous, Rule 52(a), Federal Rules of Civil Procedure, *Jerrigan v. Southern Pacific*, 222 F.2d 245 (9th Cir. 1955). If the inferences drawn from the

evidence by the trial court are those which could have been drawn by reasonable men, this court will accept those inferences. *Lundgren v. Freeman*, 307 F.2d 104 (9th Cir. 1962).

The court here found that the plaintiff failed to prove its case because the Brooks resurvey was not in fact evidence of the location of the original lines. The record is replete with evidence to support that finding, and it should stand.

Respectfully submitted,

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Attorneys for Defendants

**BRIEF ON CROSS-APPEAL**

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**STATEMENT OF JURISDICTION**

Defendants adopt and incorporate herein the Government's statement of jurisdiction as set forth in its opening brief.

**STATEMENT OF THE CASE**

This was an action by the Government for trespass. The facts and issues are well set out in the preceding briefs. At the conclusion of the case, and after both sides had presented their evidence and rested, the court found that "there was a failure of proof" (Tr. 175) on the part of the Government in that the resurveys relied on by the Government did not accurately locate the original boundary over which the Government claimed the defendants had logged. The court found against the Government on all its contentions (Tr. 174). However, the court gave judgment for defendants *without prejudice* to the Government's right to institute a new action. The question presented here is whether the court abused its discretion in dismissing without prejudice, rather than with prejudice.

**SPECIFICATION OF ERROR**

The District Court erred in dismissing without prejudice to the Government. The dismissal should have been with prejudice.



## SUMMARY OF ARGUMENT

Good cause must be shown for a dismissal to be without prejudice where the plaintiff has presented his case and failed in his proof. The law favors disposition of civil litigation on the merits, and this policy is particularly strong where the case has been fully tried on the merits. No cause has been shown why this dismissal should not be with prejudice, and none exists.

## ARGUMENT

**1. Where the plaintiff has presented his case and there is a failure of proof, good cause must exist for the dismissal to be without prejudice.**

In *Safeway Stores v. Fannan*, 308 F.2d 94 (9th Cir. 1962), this Court made it plain that good cause must exist for a dismissal to be without prejudice where it is ordered after presentation of the plaintiff's case. In that case, at the conclusion of the plaintiff's case the District Court (District of Oregon) dismissed without prejudice, following the defendant's motion for a directed verdict. The defendant appealed from the part of the judgment making the dismissal without prejudice. This Court, after finding that there had been a failure of proof, 308 F.2d at 98, and after concluding that the court had the power to dismiss on its own motion, 308 F.2d at 99, modified the judgment by making the dismissal *with* prejudice, stating as follows with regard to the

court's discretion to make a dismissal without prejudice:

"That discretion, however, is a judicial, not an arbitrary one, and we can find nothing in the present record to sustain its exercise. Counsel for Fannan made no suggestion to the court that other evidence might be procured, or that he was surprised (in a legal sense, as distinguished from the usual 'surprise' of a losing counsel), or of any other reason why the matter should not have followed the normal course to a judgment on the merits, nor has any such suggestion been made to us. The record would not support a conclusion by us that Fannan's counsel butchered the case. The judge suggests no ground other than his apparent relief [sic] that the dismissal should be 'without prejudice.'

"Under these circumstances, we conclude that the judge erred." 308 F.2d at 99.

This case is similar: There is no suggestion that other evidence might be produced. To the contrary, the resurveyor Brooks admitted that in his second resurvey of this area, he found no more additional original monuments than he found in his first resurvey (Tr. 167). There is no surprise in the legal sense, and defendants feel that counsel for the Government certainly did not "butcher" the case.

## **2. A dismissal without prejudice after a full trial on the merits is contrary to the policy of the law.**

The law favors the disposition of civil litigation on its merits. *Davis v. Parkhill*, 302 F.2d 489 (5th

Cir. 1962), *Meeker v. Rizley*, 324 F.2d 269 (CA Okla. 1963).

The policy favoring disposition of civil litigation on its merits has particular application where, as here, the cause has been submitted to the trier of fact, and there is ample evidence in the authorities of a strong policy against allowing a nonsuit or dismissal without prejudice at that stage of the proceedings:

(1) Defendants find no American jurisdiction which still permits a nonsuit as a matter of right after submission. See cases annotated 89 ALR 13.

(2) Statutes in many states have abolished even the court's discretionary power to allow a nonsuit after submission. See cases annotated 89 ALR 74.

(3) Defendants find no case under the Federal Rules of Civil Procedure granting or upholding a dismissal without prejudice after submission. To the contrary, defendants cite *Safeway Stores v. Fannan*, discussed above, and the following:

In *Moore v. C. R. Anthony Company*, 198 F.2d 607 (10th Cir. 1952), the court upheld denial of a motion for a dismissal without prejudice after submission of the cause, stating:

"The avowed purpose of the rule (Rule 41 of the Federal Rules of Civil Procedure) was to prevent the dismissal of cases without prejudice after trial and in the face of an impending unfavorable judgment." 198 F.2d at 608.



In *Piedmont Interstate Fair Association v. Bean*, 209 F.2d 942 (4th Cir. 1954), the court vacated an order allowing the plaintiff to dismiss without prejudice after service on third-party defendants, answers and preliminary motions, stating as follows:

“The voluntary dismissal of an action by a plaintiff after participation in the trial and after the judge has expressed an adverse opinion of the merits of his claim has not been favorably regarded by the courts.” 209 F.2d at 948.

Discussing the effect of the Federal Rules, the court said:

“The prejudice to the defendant which justifies the court in refusing permission to the plaintiff to dismiss is more carefully considered, and it is no longer true to say, as was so often said in the decisions preceding the Federal Rules, that ‘the incidental annoyance of a second litigation upon the subject matter’ furnishes no ground for denying the plaintiff permission to dismiss his complaint.” 209 F.2d at 946.

In *Cincinnati Traction Building Co. v. Pullman*, 25 F. Supp. 322 (D.C. Del. 1938), the plaintiff moved for a voluntary nonsuit after answer, preliminary motions, interrogatories and depositions. The court denied the motion, stating:

“Plaintiff has chosen the forum and has required defendant to answer and prepare its defense at great expense. In such case defendant is entitled to have the controversy finally adjudicated so that it may definitely know its rights.” 25 F. Supp. at 322-323.



The policy evidenced by such cases is applicable here, where the Court undertook to grant the Government a new day in court.

### CONCLUSION

After a complete trial on the merits, a strong showing must be made for granting the unsuccessful plaintiff leave to bring a new action. There was no such showing here. The Government resurveyed the land in question twice, but its surveys failed to produce proof that the boundary line was as claimed by the Government. The monuments and the land are no more capable of accurate resurvey today than they were when resurveyed twice previously. The Government has had its day in court and has failed to prove its case. The matter should be finally determined; the dismissal should be with prejudice.

Respectfully submitted,

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Attorneys for Appellees and  
Cross-Appellants.

**CERTIFICATE OF COUNSEL**

I certify that in connection with the preparation of this brief, I have examined Rules 18 and 19 of the United States Court of Appeals for the Ninth Circuit and that in my opinion, the foregoing brief is in full compliance with those rules.

JOHN R. FAUST, JR.,  
Of Attorneys for Appellees.



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IN THE UNITED STATES COURT OF APPEALS  
FOR THE NINTH CIRCUIT

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UNITED STATES OF AMERICA,

Appellant and Cross-Appellee

v.

JOHN HUDSPETH, ET AL.,

Appellees and Cross-Appellants

---

ON APPEAL FROM THE UNITED STATES DISTRICT  
COURT FOR THE DISTRICT OF OREGON

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REPLY BRIEF FOR THE UNITED STATES AS  
APPELLANT; ANSWER BRIEF FOR THE UNITED STATES AS APPELLEE

FILED

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IN THE UNITED STATES COURT OF APPEALS

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Nos. 20905, 20906

UNITED STATES OF AMERICA,

Appellant and Cross-Appellee

v.

JOHN HUDSPETH, ET AL.,

Appellees and Cross-Appellants

---

ON APPEAL FROM THE UNITED STATES DISTRICT  
COURT FOR THE DISTRICT OF OREGON

---

REPLY BRIEF FOR THE UNITED STATES  
AS APPELLANT

The Hudspeths' brief (hereinafter cited as H. Br.) fails almost completely to meet the contentions made in the Government's opening brief (cited as U.S. Br.). In addition, the Hudspeths' brief contains errors in its statement of the record.

We shall endeavor to deal, as summarily as possible, with the basic errors contained in that brief and with the specific matters in it which seems in most urgent need of correction.



I

THE HUDSPETHS' BRIEF DISREGARDS THE  
RATIO DECIDENDI OF THE DISTRICT COURT

Throughout their brief the defendants have ignored the rationale of the district court as set forth in its findings of fact and conclusions of law (R. 12) and supplemental conclusion (R. 30). Many times in their brief the defendants have erroneously stated that the critical issue and the one upon which the court's decision was based was whether the dependent resurveys were accurate (H. Br. 2, 3, 9, 12-13, 14). This is not so. The court itself concluded (Tr. 175): "Now, I am not saying that the recent survey is in error, although there are many things about it that certainly might be subject to criticism." In fact, the district court decided the case on the basis of the issue of law stated in the pretrial order (R. 9-10): "Are defendants bound by plaintiff's resurvey?" The court held that they were "not bound by, or to be held liable for, the dependent re-surveys \* \* \*" (Fdg. 3, R. 13).

Its reasoning was: (1) there were in fact timber trespasses by the defendants (Fdg. 3, R. 13); (2) the Government attempted to prove the original boundaries by dependent resurveys conducted after these trespasses had occurred; (3) dependent resurveys conducted after trespasses had occurred cannot be the basis of liability (Fdg. 3, R. 13; R. 30); (4) therefore the Government failed to meet its burden of proof: "the resurveys on which the plaintiff depends were made subsequent to the alleged trespasses" (R. 30; Fdg. 3, R. 13). This theory that the time of resurvey controls this case is emphasized by the supplemental opinion filed by the district court after the appeal was docketed (R. 30).

This reasoning is contradictory and wrong (G. Br. 19-32). The very essence of the dependent resurveys was to determine where the original boundaries are. Without relying upon the dependent resurveys there would be no way in which the court could have found that the defendants had trespassed (Fdg. 3, R. 13). The fact that the dependent resurveys were conducted after the trespasses had occurred has no effect upon the burden of proof, nor does it justify the trespasses. The case is still based upon the original



boundaries--the original boundaries are what is binding. The dependent resurveys simply reestablish what those boundaries have always been. They do not change or correct the original survey.

The defendants argue that the dependent resurveys alter the boundaries of their land (H. Br. 3, 9-12, 13). At no point in this case have they offered to show what those boundaries are. At most, they simply showed that they set their timber cutting line in a haphazard fashion (G. Br. 20-22; Tr. 145-148). The defendants entirely distort the record when they state that the Government's surveyor testified that their setting of the timber cutting line could have accurately established the original boundary (H. Br. 22). The Government surveyor's statement was qualified (R. 168): "Providing they found all original corners." By defendants' own admission, they never found any corners (R. 148). The effect of the dependent resurveys is to reestablish what the parties' rights in the lands have always been.

The arguments presented by defendants as to accuracy are really a request that this Court reconsider the facts

de novo since the district court considered and based its decision on the binding effect of the dependent resurveys and not upon their accuracy.

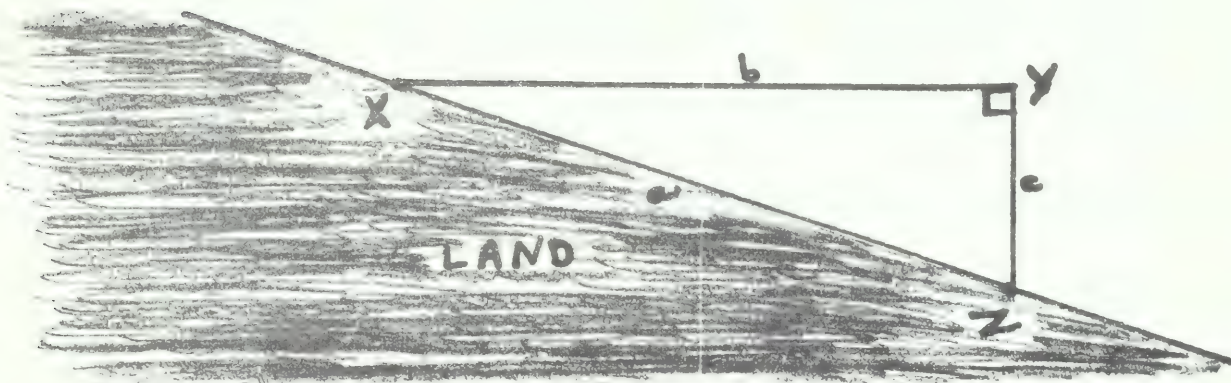
## II

### THE HUDSPETHS' BASIC MISCONCEPTION OF THE RECORD

A. The resurveys reconstructed and reestablished the lines of the original survey. - The very purpose of the dependent resurveys was to determine where, on the ground, the original boundaries were set (Ex. 6-8; Tr. 9-12, 27-28, 33, 64-65, 89-90). Defendants argue that the techniques used in making the resurveys in 1959 and 1962 and the measurements taken differ significantly from those of the original 1872 survey (H. Br. 15-22). First of all, the techniques of surveying have improved since 1872. But that makes no difference. The cadastral surveyor conducting a dependent resurvey must perform a bit of detective work to retrace the original surveyor's footsteps. He need not re-enact the 1872 survey with 1872 instruments. He must simply uncover on the ground the results of the original survey. Second, the references in the Hudspeths' brief to "discrepancies" between the measurements of the original survey and the dependent resurveys are meaningless (H. Br. 4, 15-22). Such argument amounts to a complete distortion of the record. The so-called "discrepancies" result from different units of measure being used in each of the surveys (R. 62-63, 26, 36-37).



The original surveys were performed in terms of slope measurements while the resurveys were performed in terms of horizontal measurements. Horizontal measurements will be numerically less than slope measurements though they describe the same boundary. This can be simply illustrated by the example.



For example, by the original survey the distance XZ would be given in terms of "a," i.e., slope. The resurveys would report the same distance, XZ, in terms of "b," i.e., horizontal. Thus, while the number of units in "a" differs from "b," each describes the same distance, XZ. ("a" will generally be greater than "b" since, according to the Pythagorean theorem of elementary geometry,  $a^2 = b^2 + c^2$ .) However, in conducting the resurveys, slope distances were used in searching for the original corners (Tr. 62-63).

Furthermore, it is a well-established principle that indications of a boundary on the ground control over those on paper. United States v. State Investment Co., 264 U.S. 206, 211-212 (1924); McIver's Lessee v. Walker, 13 U.S. (9 Cranch) 173, 177 (1815); Horne v. Smith, 159 U.S. 40 (1895); 1 Patton, Land, Titles (2d ed. 1957) sec. 149, pp. 390-396; 4 Tiffany, Real Property (3d ed. 1939) sec. 994, pp. 96-100. Field notes and plats are secondary evidence of what the surveyor actually did on the ground. Thus, even if the units of measure were the same, it would be meaningless to contrast a dependent resurvey based upon evidence of the original survey on the ground with the field notes and plats. Appellees' argument about "accuracy" is largely based on the notion that a survey like a mathematical formula can be "absolutely correct." Unfortunately, that is not so. Surveys are only relatively accurate, and the result is that in the many instances where the actual surveys do not on the ground follow the ideal grid of a township, so also the physical monuments do not necessarily jibe with the field notes and the plat. Restoration of lost corners by proportionate measurement is only resorted to when every other means of identifying the original positions has been exhausted.



B. The administrative nature of the resurveys was clearly before the court. - In the pretrial order, under "agreed facts," it was stated that the dependent resurveys were "accepted and approved by the Secretary of the Department of Interior \* \* \*" (Nos. 6, 7, R. 8). In the findings of fact and conclusions of law, the district court itself stated that the dependent resurveys were accepted by the United States (Fdg. 3, R. 13). Floyd A. Brooks, who conducted the resurveys, was a cadastral surveyor with the Department of the Interior, Bureau of Land Management (Tr. 9). His instructions were from the United States Department of the Interior, Bureau of Land Management (Ex. 7, 8; Tr. 10-12). Irving Zirpel, Jr., testified that in Oregon and Washington he was Chief of the Branch of Cadastral Engineering, United States Department of the Interior, and that he reviewed and checked Brooks' work (Tr. 29, 86-87).

Furthermore the Manual of Surveying Instructions (Dept. of the Interior, 1947) was the standard for determining the accuracy of the dependent resurveys. The instructions, offered and received in evidence, for making the resurveys recited the fact that the Manual was the basic standard

(Ex. 7, 8). "In the execution of the retracements and resurveys \* \* \* you \* \* \* will be guided by the Manual of Surveying Instructions, 1947, the provisions of the following special instructions, and such supplemental instructions as may be issued pursuant to the report of complications developed during the progress of the work, or by reason of additional authorization." "Any and all original corners found in the course of your retracements will be rehabilitated by re-monumentation \* \* \* as directed by Secs. 238 and 325 of the Manual." "You will extend your retracements to the boundary lines of adjacent sections in any cases where such action becomes necessary in the development of control for the restoration of any corner \* \* \* setting iron corner monuments in conformity with Manual procedure." "Any and all lost corners of the sections for resurvey will be restored by the appropriate method of proportionate measurements which are described in detail, along with other pertinent matter, in Secs. 348 to 408, inclusive, of the Manual."

Thus, contrary to the defendants' allegation (H. Br. 3, 12-13, 15), the Manual has played a significant role in this case. Only by determining whether a resurvey was performed in accordance with the Manual can its accuracy be



determined. The resurvey reestablishes the original survey on the ground. There is nothing else on the ground with which to compare it. The original field notes and plats are secondary evidence. It is what the original surveyor did on the ground that controls. The resurveys here were made in conformity to the Manual; thus they were not arbitrary or capricious acts and should have been upheld.

The defendants characterize their attack on the administrative action as a so-called "defense". Where one attacks the validity of an administrative decision he must first exhaust his administrative remedies. No such showing was made. Defendants assert that the need to exhaust their administrative remedies is "inapplicable" (H. Br. 2, 6). They failed to make a direct attack upon the administrative decision and should have been barred from making a collateral attack. Poulos v. State of New Hampshire, 345 U.S. 395 (1952) (the remedy for denial of a license was by direct attack and not by violation of the decision and collateral attack when it was enforced); National Labor Relations Board v. Pappas & Co., 203 F.2d 569 (C.A. 9, 1953); Reconstruction Finance Corp. v. Lightsey, 185 F.2d 167 (C.A. 4, 1950);

United States v. Slobodkin, 48 F.Supp. 913, 917 (D. Mass. 1943). Defendants should have directly appealed to the Bureau of Land Management and then, if necessary, to the Secretary of the Interior (G. Br. 12-16). See, Best v. Humboldt Mining Co., 371 U.S. 334, 338-340 (1963).

#### CONCLUSION

For the foregoing reasons, it is submitted that the judgment below should be reversed and the case remanded to the district court with detailed instructions in accordance with the law. The effect of the defendants' argument is that the location of the boundaries can never be determined. They state (H. Br. 32): "The monuments and the land are no more capable of accurate resurvey today than they were when resurveyed twice previously." Such a conclusion is impossible. It is absurd to reach the legal result that because of the requirements of proof proposed by the court, which cannot be met, the court will require the title to a tract of land forever to be in limbo. Except for the guilt of trespass, appellees would be the first to complain of such a result of refusing to remove a cloud on their title.



ANSWER BRIEF FOR THE  
UNITED STATES AS APPELLEE

For the purposes of this cross-appeal it must be assumed that the district court's findings of fact and conclusions of law and supplemental conclusion are correct. Then the question becomes: Whether it was within the district court's discretion to dismiss without prejudice the Government's case when the defendants had in fact trespassed and <sup>1/</sup> cut timber on public lands.

ACTION BASED ON RESURVEYS TO WHICH  
TRESPASSING DEFENDANTS ARE NOT BOUND  
CAN BE DISMISSED WITHOUT PREJUDICE

The district court found that the defendants had in fact trespassed. "The evidence establishes that such trespasses occurred, but since the plaintiff tried the case on the basis of the alleged dependent re-surveys there was no way that the Court could fix the extent of such trespasses" (Fdg. 3, R. 13). The court found that the United States had

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1/ On appeal for the first time the defendants are objecting to the nature of the disposition of the case. At trial, the court announced that it was going to dismiss the case without prejudice (Tr. 175). The defendants were silent. They did not even file a motion for amendment of the judgment. The district court was never apprised of the defendants' position so that it might correct its ruling if in error. This failure to make timely objection should, in itself, preclude defendants from raising the matter on appeal.

a claim on which relief could be granted, but had wrongly relied upon the resurveys instead of the original survey. The defendants, the court said as a matter of law, are not bound by the resurveys because they were performed subsequent to the trespasses (Fdg. 3, R. 13; Supp. Concl., R. 30). Therefore, the court concluded, the Government's case should be dismissed without prejudice, subject to the Government's right to bring a suit based upon the original survey (Concl. of Law, R. 13). No abuse of discretion occurred and good cause existed for such disposition. An error of proof which can be remedied should not be fatal to the plaintiff and release the wrongdoer from any liability.

Furthermore, a dismissal with prejudice would have created an impossible situation. Such a disposition would have gone to the merits of the case. As between the United States and the defendants, its effect would have been to put title in the defendants. However, the defendants never proved their boundaries and never proved their title to the lands in dispute (G. Br. 20-22, 26). They even stated that it would



be impossible to accurately reestablish the boundaries (H. Br. 32; supra p. 11). And the court seems to have assumed that suit would lie for any trespasses occurring after the resurvey. Thus dismissal without prejudice was the bare minimum to which the United States was entitled.

#### CONCLUSION

For the foregoing reasons, the defendants should not prevail in their appeal from the district court's "dismissal without prejudice."

Respectfully submitted,

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SIDNEY I. LEZAK,  
United States Attorney,  
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WILLIAM M. COHEN,  
Attorneys, Department of Justice  
Washington, D. C., 20530.

DECEMBER 1966

CERTIFICATE OF EXAMINATION OF RULES

I certify that, in connection with the preparation of this brief, I have examined Rules 18 and 19 of the United States Court of Appeals for the Ninth Circuit, and that, in my opinion, the foregoing brief is in full compliance with those rules.

William M. Cohen

WILLIAM M. COHEN,

Attorney, Department of Justice,  
Washington, D. C., 20530.



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UNITED STATES COURT OF APPEALS  
FOR THE NINTH CIRCUIT

---

ERLE G. SWANSON and  
HELEN F. SWANSON,  
husband and wife,

Appellants,

v.

COMMERCIAL ACCEPTANCE  
CORPORATION, a Missouri  
corporation,

Appellee.

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APPELLANTS' BRIEF

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Appeal from the United States District Court for the  
District of Oregon

THE HONORABLE WILLIAM G. EAST, Judge

---

FILED

JUN 18 1966

DENTON G. BURDICK, JR.  
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WM. B. LUCK, CLERK

Attorneys for Appellants

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UNITED STATES COURT OF APPEALS  
FOR THE NINTH CIRCUIT

---

ERLE G. SWANSON and  
HELEN F. SWANSON,  
husband and wife,

Appellants,

v.

COMMERCIAL ACCEPTANCE  
CORPORATION, a Missouri  
corporation,

Appellee.

---

APPELLANTS' BRIEF

---

Appeal from the United States District Court for the  
District of Oregon

THE HONORABLE WILLIAM G. EAST, Judge

---

STATEMENT OF JURISDICTION

On February 24, 1964, appellants, both citizens and residents of the State of Washington, filed a civil action against The Fuline Corporation and Commercial Acceptance Corporation, both Missouri corporations, with places of business in that state (R.1). The amount in controversy



exceeds \$10,000 (R.1, 44-45). Jurisdiction in the District Court was based on 28 U.S.C. §1332. On November 6, 1964, the court ordered that the issue as to whether the appellee, Commercial Acceptance Corporation, was a holder in due course be segregated and tried prior to the trial of the remaining issues (R.81). It was agreed that if the appellee was a holder in due course, it was entitled to judgment on its counterclaim (R. 52,53). After the trial on the segregated issue, the court determined that there was no just reason for delay in the entry of a final judgment upon such issue and directed entry of a final judgment in favor of the appellee, Commercial Acceptance Corporation, and against the appellants (R. 103). Appellants filed a timely notice of appeal (R. 107) from such final judgment (R. 107). The jurisdiction of this court is conferred by 28 U.S.C. §1291 and Rule 54(b) of the Federal Rules of Civil Procedure.

#### STATEMENT OF THE CASE

There is no dispute concerning the facts. They were set forth in an agreed statement of facts in the pre-trial order (R. 45-53), a stipulation of agreed testimony (Ex. 73), and the court's findings of fact based thereon and on the agreed documentary exhibits. The only question is whether or not the lower court was correct in its conclusion of law that the appellee was a holder in due course of two notes and, as such, took them free from defenses (R. 101).





On April 27, 1962, appellants applied to The Fuline Corporation (a defendant in the lower court but not an appellee in this court -- hereinafter called "Fuline") for a Fuline franchise under which appellants would purchase coffee-dispensing machines and operate them pursuant to the Fuline program (R.87). This application gave the background information concerning appellants, including their financial statement (Ex. 10-A).

Appellee is engaged in the business of purchasing commercial paper. During the three years prior to the transaction in question it had purchased from Fuline some 23 accounts totaling \$391,000 out of purchases of similar paper from all sources approximately \$3,100,000 (R.89, 90). On April 30, 1962, Fuline delivered to appellee a copy of appellants' application for a franchise, a copy of the verification of appellants' bank deposit (Ex. 10-B), and a written request for financing covering 40 coffee machines to be financed for appellants. This application contained a breakdown of the cost, down payment, finance charges, and monthly payments proposed (R.87, Ex.10-C). On the same date, the request for financing by Fuline was approved by appellee and Fuline was so advised. Fuline, in turn, advised appellants that their credit had been approved by the finance company (Ex. 2) and, on or about the same date, appellants and Fuline entered into the contemplated franchise agreement (R.87, Ex. 3).

On June 12, 1962, appellants purchased 40 coffee machines from Fuline. They executed in the State of Washington and



delivered to Fuline in the State of Kansas and payable there their written promissory note secured by a purchase-money mortgage on the machines (R. 87, 88). The purchase money mortgage and note (Ex. 6) contained the exact price, finance charges, and terms of sale which had been approved by appellee on April 30, 1962. The note and mortgage are on printed forms furnished by a corporation known as "Commerce Acceptance Company, Inc.", the parent corporation of appellee (R. 88, 89). The printed form of note and printed form of mortgage were attached together on the same piece of paper or form and included as a part thereof a printed form of endorsement to Commerce Acceptance Company, Inc. (Ex. 6, R.88,89). On June 13, 1962, for value paid by it, appellee purchased the foregoing note and mortgage after Fuline had executed the printed assignment on the mortgage and the endorsement on the note (R. 48, 89).

Late in May of 1962, Fuline made a telephone request of the appellee that it add an additional 20 dispenser machines to its earlier expressed approval of the request for the financing of the 40 machines on substantially the same terms approved by appellee (R.88).

On or about June 28, 1962, appellants purchased the 20 additional machines, made a down payment, and executed in the State of Washington and delivered to Fuline the second of the two promissory notes and purchase-money mortgages here involved. The note and mortgage are on identical printed forms provided by Commerce Acceptance Company, Inc. and having the same printed assignment and endorsement to Commerce Acceptance





Company, Inc. This note and mortgage was purchased by appellee on June 28, 1962 after the printed endorsements and assignments had been executed by Fuline (R. 48, 88, 89). The mortgaged coffee machines were situated in Clark County, Washington, and Multnomah County, Oregon (R. 46).

It was an agreed fact and the court found that appellee paid value for the notes prior to their maturity and without any notice of a defect in the title of Fuline or of any defense as far as the notes are concerned (R.91). The court concluded, as a matter of fact, that the naming and designating of Commerce Acceptance Company, Inc. was due to the mutual mistake and inadvertence of Fuline and appellee and that it was the mutual understanding and intention of the appellants, appellee and Fuline if notes were sold to appellee that they were to be transferred to it by proper endorsements and assignments by Fuline (R.92). It was agreed, and the court found, that Commerce Acceptance Company, Inc. never had any interest in or claim to the notes or their securing mortgages.

Subsequent to the commencement of these proceedings, Fuline executed and delivered to appellee a "Corrected Assignment" for each note and mortgage and a later "Correction, Clarification and Amendments of Corrected Assignment" for each note and mortgage (R. 92, Exs. 8,9,105,106). These documents were either acknowledged by Commerce Acceptance Company, Inc. or it was a party to each of these documents (R.92). Included as appendices to this brief are copies of Exhibits 8 and 105. Exhibits 9 and 106 are identical in text but relate to the



second of the notes and mortgages.

On February 24, 1964, appellants brought this action which is a suit to rescind the purchase of the coffee machines because of alleged breaches of warranty, defects in the machines, failure of the machines to meet electrical code requirements, etc. (R.1-4). Regardless of the merits of appellants' claim, it, of course, cannot be asserted against a holder in due course. By agreement and order of the court, this issue was segregated without any hearing as to the merits of appellants' claim (R.81). Since the holder in due course issue was resolved in favor of appellee, a final judgment was entered in its favor for the full amount due on the notes and the mortgages were ordered foreclosed. The lower court determined that there was no just reason for delay in entering a final judgment upon the appellee's counterclaim (R.103).

#### SPECIFICATION OF ERROR

The District Court erred in concluding that the appellee was a holder in due course and thus took the notes free of defenses. Such conclusion of law is erroneous because

(a) appellee participated in the transaction prior to the time the notes were drawn and therefore the negotiable instrument law was not applicable to the subsequently-issued notes which appellee was committed to purchase; and

(b) if the negotiable instruments law is applicable, there was no proper endorsement of the notes, and therefore





the appellee does not meet the statutory requirements for being a holder in due course.

#### SUMMARY OF ARGUMENT

Appellants are entitled to be heard on the merits unless the appellee is a holder in due course of a negotiable instrument. There are two equally valid reasons for holding that the appellee was not a holder in due course. In the first place, appellee participated in the transaction in question from its inception. Prior to the time the notes were written, the contemplated transaction was fully presented to the appellee with details concerning the property to be sold, the sales price, the finance charges, the terms of payment, and the names, addresses and financial standing of the prospective makers. The appellee approved an application and request to finance the transaction as submitted. The subsequently-drawn notes and mortgages were on forms supplied by appellee and in compliance with the appellee's commitment and contractual agreement to purchase the notes when tendered to it. Almost all enlightened courts have held that the foregoing facts would make the negotiable instrument law inapplicable. Independently of the foregoing, there was no proper endorsement of the notes in question to the appellee at the time the notes were purchased. The endorsements were only corrected after this action was commenced.



(a) The Negotiable Instruments Law Is Inapplicable  
Because Appellee Participated in the Transaction  
From Its Inception.

The lower court declined to deal with any conflict of law issues concluding that it was unnecessary to decide whether Missouri, Washington, Oregon, or Kansas law applied. At the applicable date each of the states had identical statutes. As to the case law concerning whether or not the negotiable instrument law is applicable, we see no difference in the laws of any of these states. However, as we will point out in the second portion of this brief, we believe that the law of the State of Oregon applies. Therefore, since this is a diversity case, the Oregon Supreme Court, under almost identical situation to the case at bar, held that where there was no proper endorsement of an instrument, it was subject to the defenses.

The applicable provisions of the negotiable instruments law are as follows:

71.191 Definitions. In this chapter, unless the context otherwise requires:

\* \* \*

"Holder" means the payee or indorsee of a bill or note who is in possession of it, or the bearer thereof.

71.030 What constitutes negotiation. An instrument is negotiated when it is transferred from one person to another in such manner as to constitute the transferee the holder thereof. If payable to bearer, it is negotiated by delivery; if payable to order, it is negotiated by the indorsement of the holder completed by delivery.





A holder in due course is a holder who has taken the instrument under the following conditions:

- (1) That it is complete and regular upon its face;
- (2) That he became the holder of it before it was overdue, and without notice that it had been previously dishonored, if such was the fact;
- (3) That he took it in good faith and for value;
- (4) That at the time it was negotiated to him he had no notice of any infirmity in the instrument or defect in the title of the person negotiating it.

71.057 Rights of holder in due course.  
A holder in due course holds the instrument free from any defect of title of prior parties, and free from defenses available to prior parties among themselves, and may enforce payment of the instrument for the full amount thereof against all parties liable thereon.

The above section numbers conform with the numbers in the negotiable instrument law and are the Oregon Revised Statutes in effect on the date of the transaction in question.

Appellants are making no claim here nor did they claim in the lower court that there was any lack of good faith on the part of the appellee, or that the appellee had any knowledge of defenses on the part of the appellants. What the appellants do contend is that while no single factor to be considered in and of itself would prevent the appellee from being a holder in due course, because of the combination of



factors found by the lower court, the negotiable instruments law has no application. Therefore, the ordinary rules applying to the assignment of a chose in action are applicable and appellants are not deprived of their defenses.

In almost all of the modern cases and, with few exceptions in the order cases, where the following circumstances exist, the endorsee of a note is not treated as a holder in due course. Such circumstances are:

(a) There is a history of past dealings between the payee and the endorsee, and the endorsee has been engaged in financing transactions for the payee.

(b) Prior to the purchase of the note, the endorsee is consulted in regard to the contemplated transaction, it examines the same, it obtains information concerning the prospective maker's credit, and approves the amount and terms of the note.

(c) The endorsee gives its commitment to purchase or discount the instrument when it is issued and tendered to it.

(d) The endorsee furnishes its printed form of note and mortgage, including a printed endorsement and assignment to the endorsee (the same being printed on the same sheet of paper).

(e) Pursuant to the foregoing arrangement, the instrument is prepared for the contemplated makers in accordance with the agreed terms, and is then purchased or discounted





by the endorsee.

There are numerous cases which hold that where one or more of the above factors are present, this does not necessarily prevent the endorsee from being a holder in due course. We make no contention that it does. In this connection, see the annotation in 44 ALR 2d at page 8, "Transferee of commercial paper given by purchaser of chattel and secured by conditional sale, retention of title, or chattel mortgage, as subject to defenses which chattel purchaser could assert against seller." However, where all of the above factors are present, as they are here, this constitutes active participation in the transaction. Where the finance company has actively participated in the transaction, it is in no position to state that it was a purchaser of a negotiable instrument within the meaning of the negotiable instruments law, and the courts so hold.

One of the leading cases is Commercial Credit Corp. v. Orange County Machine Works, 34 Cal.2d 766, 214 P2d 819, where the defense was basically the same as the defense in the case at bar, i.e., it did not involve fraud. In that case, just as in the case at bar, the finance company was approached by the seller and asked to finance the transaction. Definite arrangements were made to do so. The sale was then made using the finance company's forms. There was no evidence that the finance company had acted in bad faith or had any knowledge that there was a failure of consideration for the note at the



time it purchased it. The Supreme Court of California, in holding that the finance company was not a holder in due course, summarized the situation as follows:

"When a finance company actively participates in a transaction of this type from its inception, counselling and aiding the future vendor-payee, it cannot be regarded as a holder in due course of the note given in the transaction and the defense of failure of consideration may properly be maintained."

Another factually similar and relatively recent case is Mutual Finance Company v. Martin, Fla., 63 So. 2d 649, 44 ALR 2d 1. There the facts are identical to those in the case at bar. There was a history of dealings between the finance company and the payee of the note. Before the note was issued, the finance company investigated the credit standing of the prospective buyer and agreed to purchase the contract and note in the event the prospective transaction was consummated. The finance company's printed form of assignment was used in drawing up the papers which were purchased by the finance company immediately upon their execution. It was not intimated or suggested that the finance company acted in bad faith or had any actual knowledge or information concerning defenses. The court was not willing to say that it would follow the rule in some states that if the note and mortgage were executed concurrently, they would be subject to defenses or, because they were on the same piece of paper, that this would make it subject to defenses. The court held that because of a





combination of all of these factors, plus the participation of the finance company in the arrangements leading up to the issuance of the note, prevented them from being given the treatment granted to a holder in due course under the negotiable instruments law.

Other like, well-reasoned cases are:

Commercial Credit Co. v. Childs, 199 Ark 1073,  
137 SW 2d 260

Schuck v. Murdock Acceptance Corp.,  
220 Ark 56, 247 SW 2d 1.

Since this case was tried, there are two additional cases that support our position. In International Finance Corporation v. Rieger, \_\_\_\_\_ Minn. \_\_\_\_\_, 137 NW 2d 172, decided August 27, 1965, the situation was the same as in the case at bar. The finance company had arranged to purchase the note in question prior to the time that the same was executed, and its forms were used. There the lower court had held that the paper was subject to defenses, and, in affirming, the Supreme Court stated:

"This is consistent with numerous decisions from various jurisdictions, including Minnesota, which hold that where a note has been executed concurrently with a conditional sale contract, an assignee of the note and conditional sale contract, who has participated in the transaction from its origin so as to have acquired knowledge of the conditional liability of the purchaser or maker of the note, does not become a holder of the note in due course."



Appellee had full notice that Fuline was selling the machines in question to appellants and that the note and the installments due thereon were in payment for the machines.

In the other recent case, Industrial Credit Company v. Mike Bradford & Co., \_\_\_\_\_ Fla. \_\_\_\_\_, 177 S 2d 878, the note was subject to defenses because

"The record indicates.....appellant had investigated and approved the credit of appellees; appellant had furnished the agreement and note executed and had approved their terms....".

In United States v. Klatt, 135 F Supp 648, the United States was suing on a Federal Housing Administration Title I note which had been discounted by the Bank of America. If the Bank of America was a holder in due course of the note, then the United States was entitled to prevail. There, as here, the bank had been in on the transaction from the beginning in that they were to finance it and had furnished the forms to be signed by the purchaser. Based upon the authorities upon which we rely, the court concluded as follows:

"\*\*\*the relationship between the payee named in the instrument in suit and the bank, as to the entire transaction giving rise to the instrument, was such that the bank must be considered in effect a party to the original transaction between the named-payee dealer and the defendant; and the bank could not, therefore, in any event, be deemed a holder in due course of any negotiable instrument, executed as a part of the transaction."





(b) Appellee Cannot Be a Holder in Due Course  
Because the Endorsement to It Was Defective  
on Its Face.

This being a diversity case, the Court should apply the law which would be applied by the Oregon Supreme Court. Therefore, it is necessary to determine first what law would be applied, and then determine what the result would be under that law.

The counterclaim seeks to foreclose the chattel mortgages on the coffee machines situated in the State of Oregon. While the mortgages were actually executed in the State of Washington, they constituted a lien on personal property in the State of Oregon. The problem of the applicable state law arose in the District of Oregon in the unreported case of Challenge-Cook Bros., Inc. v. Topline Equipment Co., Civil 63-278. In that case the plaintiff brought a civil action to obtain a judgment on a note and foreclose the securing trust receipt (lien on personal property). The note was payable in California, but the personal property covered by the trust receipt was situated in the State of Oregon. The precise question involved was the application of the appropriate parol evidence rule, it having been conceded that such rule is a matter of substance and not procedure and the ordinary rules of conflicts determine the choice of the law to be applied. In holding that the Oregon court would apply the law of the State of Oregon, the Honorable John F. Kilkenny cited the Oregon authorities and



stated his reasons for such conclusion, as follows:

"Washington Investment Ass'n. v. Stanley, 38 Or.319, 63 Pac. 489 (1901), on which plaintiff relies in support of its contention that Oregon law should be applied lends support to that position. The later Oregon cases of Casner v. Hoskins, 64 Or.254, 128 Pac.841 (1912), on rehearing 64 Or. 282, 130 Pac. 55 (1913); Eli Bridge Co. v. Lackman, 124 Or. 592, 265 Pac. 435 (1928) and Sterrett v. Stoddard Lumber Co., 150 Or. 491, 46 P.2d 1023 (1935), on a casual perusal would seem to support defendant's theory that where a bill or note is executed in one state and made payable in another, its nature, validity, interpretation and effect is governed by the lex loci solutionis, i.e., the law of the state in which it is payable.

"A closer analysis of these cases leads to the conclusion that they lack authority on these facts. The Washington Investment case is more in point. There, the Oregon court was considering a note and a mortgage on Oregon property, the note being payable in Washington. Here, the note and the trust receipt were executed in Oregon, the trust receipt creating a lien on property in Oregon, with the note payable in California. It is my belief that if the Oregon court was faced with this precise problem, it would follow the law stated in Washington Investment and apply the Oregon law on the effect of the parol evidence rule. Additionally, such an interpretation would conform to the general rule as asserted in Restatement, Conflict of Laws, §599, §312; 3 Beale, Conflict of Laws, §599.1. That the Oregon court considers the Restatement, including First National Bank of Portland v. Noble, 179 Or.26, 69, 168 P.2d 354 (1946), and Daniels v. Parker, 209 Or.419, 306 P.2d 735 (1957)."

We submit that under the laws of the State of Oregon, it is clear that the appellee would not be a holder in due course because there was no proper endorsement. While it is true that the appellee purchased the notes in question and the endorsee, Commerce Acceptance Company, Inc., had no interest in the notes, nevertheless the fact remains that the endorsement





did run to Commerce Acceptance Company, Inc. and not to the appellee. This is the identical situation in First National Bank v. McCullough, 50 Or 508, 93 P 366. In that case, the endorsement was as follows: "Pay A. B. Nixon or Order".

A. B. Nixon was the cashier of the plaintiff bank which had purchased the note for value without notice and before maturity. The lower court had instructed the jury, as a matter of law, that the note was subject to defenses. In affirming, the court stated:

"The uniform practice of merchants in transferring credits, represented by commercial paper, as a means of purchasing goods or settling accounts, gave rise to certain rules, demanded by the wants and convenience of trading communities, which are known as the law merchant, and have become a part of the common law: (citing cases) An observance of these rules requires that the property represented by a promissory note, payable to order, when transferred to a designated party before maturity for a valuable consideration and without notice, should be evidenced by an indorsement on the instrument, or on a paper attached thereto, in order to bar the equities of antecedent parties. This method of transferring such property constitutes the ordinary or usual course of business, a departure from which is equivalent to a notice of equities, and subjects the negotiable instrument to defenses in the hands of a holder who has acquired a right thereto in any other manner; (citing cases)."

Although the lower court distinguished this case on the ground that it was not clear from the opinion as to whether or not it was Nixon or the plaintiff bank who actually purchased the note, an examination of the Supreme Court of Oregon briefs in this case, which contain extracts from the bill of exceptions in this case, make it clear that it was the bank which



purchased the note. Therefore, what the court states should be read in the light of this fact. The situation is no different in this Oregon case than it was in the case at bar. Everything that could be said here is said there. There was no question but what the bank had the right to sue on the note and was the owner thereof. The same is true here. Appellee owned the two notes in question and had the right to sue on them. However, the ordinary rules of assigned choses in action apply. Hence the appellants are not deprived of their day in court as far as their defenses are concerned.

The situation in regard to this faulty endorsement adds support to the first portion of our brief. This is not a case in which commercial paper in the channels of commerce was discounted by appellee. If that had been the case, certainly appellee would not have purchased such commercial paper with an endorsement running to some entirely different corporation. This merely shows that in truth and in fact the notes, including all of their terms and conditions, were issued to comply with the commitment of the appellee that it would finance the transaction in question. When appellee purchased the notes, it was not buying commercial paper --- it was merely complying with its existing contractual duty and obligation to purchase the notes of these two particular makers (the appellants), provided they were in the amounts, including principal, finance charges, and monthly payments, in accordance with Fuline's approved applications for approval of financing (see Exhibit 10-C).





## CONCLUSION

The judgment entered herein in favor of the appellee should be vacated and this action should be returned to the lower court for a trial on the merits.

Respectfully submitted,

DENTON G. BURDICK, JR.  
HUTCHINSON, SCHWAB & BURDICK



CERTIFICATE

I certify that, in connection with the preparation of this brief, I have examined Rules 18 and 19 of the United States Court of Appeals for the Ninth Circuit, and that, in my opinion, the foregoing brief is in full compliance with those rules.

DENTON G. BURDICK, JR.

Of Attorneys for Appellants





APPENDIX A  
(Exhibits)

All of the exhibits are identified in the pre-trial order (R.70 to 73). The following table refers to the record pages where the exhibits were offered and received:

<u>Exhibit No.</u>	<u>Offered</u>	<u>(R. Tr.) Received</u>
1	3	3
2	3	3
3	3	3
4	3	3
5	3	3
6	3	3
7	3	3
8	3	3
9	3	3
10-A	3	3
10-B	3	3
10-C	3	3
73	5	5
101	3	4
102	3	4
103	3	4
104	3	4



<u>Exhibit No.</u>	<u>Offered</u>	<u>Received (R. Tr.)</u>
105	3	4
106	3	4
110	3	4
111	3	4





## APPENDIX B

The following is a copy of Exhibit 8:

CORRECTED ASSIGNMENT

WHEREAS, the undersigned, THE FULINE CORPORATION, for a valuable consideration sold to Commercial Acceptance Corporation a certain promissory note dated June 12, 1962 in the principal sum of \$23,871.24, made by Earle G. Swanson & Helen F. Swanson, as makers, to the order of the undersigned, as payee, secured by a purchase money chattel mortgage covering forty hot drink dispensers, and

WHEREAS, by mistake the assignments of such promissory note and such chattel mortgage erroneously stated the name of the assignee to be "Commerce Acceptance Company, Inc." rather than "Commercial Acceptance Corporation", although Commercial Acceptance Corporation furnished the consideration for such purchase and it was intended that such promissory note and chattel mortgage would be assigned to Commercial Acceptance Corporation,

NOW, THEREFORE, the undersigned hereby sells, assigns, transfers, sets over and conveys unto Commercial Acceptance Corporation all of its right, title, and interest in and to that certain promissory note dated June 12, 1962 in the principal sum of \$23,871.24 made by Earle G. Swanson & Helen F. Swanson to the order of The Fuline Corporation and that certain purchase money chattel mortgage dated June 12, 1962 covering forty hot drink dispensers, securing such note, together with any and all guarantees, agreements, and other collateral instruments; such assignment to be for the express purpose of correcting a prior assignment by the undersigned of such note, chattel mortgage and other instruments, heretofore made erroneously to "Commerce Acceptance Company, Inc." instead of to Commercial Acceptance Corporation.

IN WITNESS WHEREOF, the undersigned has hereunto executed this corrected assignment.

THE FULINE CORPORATION

By A. A. GRIFFITH  
President

This corrected assignment is hereby acknowledged:

COMMERCE ACCEPTANCE COMPANY, INC.

By D. C. HUTCHINSON  
Vice President





## APPENDIX C

The following is a copy of Exhibit 105:

CORRECTION, CLARIFICATION AND AMENDMENT OF  
"CORRECTED ASSIGNMENT"

WHEREAS, the undersigned, The Fuline Corporation, for a valuable consideration paid by Commercial Acceptance Corporation, sold and delivered to Commercial Acceptance Corporation a promissory note dated June 12, 1962 in the principal sum of \$23,871.24 made by Earle G. Swanson and Helen F. Swanson, makers to the order of the undersigned, The Fuline Corporation, as payee, which said note was secured by chattel mortgage dated June 12, 1962 executed by the said Earle G. Swanson and Helen F. Swanson as Mortgagor in favor of The Fuline Corporation as Mortgagee, which said chattel mortgage was sold and delivered to Commercial Acceptance Corporation, and

WHEREAS, the said promissory note was endorsed by The Fuline Corporation to Commercial Acceptance Corporation by execution of the writing on the reverse side of said note, which said endorsement misspelled and wrongly designated the name of Commercial Acceptance Corporation as "Commerce Acceptance Company, Inc.", and

WHEREAS, the said chattel mortgage was assigned by The Fuline Corporation to Commercial Acceptance Corporation by the execution of a writing on the second page of said chattel mortgage below the word "ASSIGNMENT", which said assignment inadvertently misspelled and wrongly designated the name of Commercial Acceptance Corporation as "Commerce Acceptance Company, Inc.", and

WHEREAS, Commerce Acceptance Company, Inc. was and is a corporation which is the 100% owner of Commercial Acceptance Corporation, and

WHEREAS, at no time did, nor was it intended that, Commerce Acceptance Company, Inc. (a) purchase or agree to purchase the said note and chattel mortgage (b) pay or give any consideration in payment for said note and chattel mortgage (c) receive possession or title to said note and chattel mortgage or (d) become a holder or an endorsee of said note, and

WHEREAS, by an undated instrument entitled "CORRECTED ASSIGNMENT" (hereinafter called the "Corrected Assignment") executed by The Fuline Corporation and acknowledged by Commerce Acceptance Company, Inc., a copy of which "Corrected Assignment" is attached hereto, The Fuline Corporation attempted and intended to indicate and acknowledge the true state of the facts and intentions of the parties with respect





pendix C (continued)

o said note and chattel mortgage, as said facts are set forth in the preceding four paragraphs herein, but in so doing language was utilized in said "Corrected Assignment" which did not set forth the true state of the facts and which incorrectly set forth the acts of The Fuline Corporation which were intended to be carried out and expressed by said "Corrected Assignment", and

WHEREAS, The Fuline Corporation desires to amend and correct the said "Corrected Assignment" so as to correctly set forth the facts and to correctly express and carry out the intention and acts of The Fuline Corporation;

NOW THEREFORE, the undersigned The Fuline Corporation hereby amends, modifies and corrects the said "Corrected Assignment" by:

1. Deleting the first two paragraphs of said "Corrected Assignment" and substituting therefore the first four paragraphs set forth hereinabove in this instrument and

2. Deleting the third paragraph of said "Corrected Assignment" and substituting therefore the following:

"NOW THEREFORE, (a) the undersigned hereby acknowledges and states that that certain assignment by it to Commercial Acceptance Corporation of the above described chattel mortgage inadvertently misspelled and wrongly designated the name of said Commercial Acceptance Corporation as "Commerce Acceptance Company, Inc." and the words "Commerce Acceptance Company, Inc." in said Assignment of chattel mortgage are hereby corrected to read "Commercial Acceptance Corporation" and (b) the undersigned hereby acknowledges and states that that certain writing executed by it on the reverse side of said promissory note was, and was intended to be, an endorsement of said note to Commercial Acceptance Corporation and that said endorsement of said note inadvertently misspelled and wrongly designated the name of said Commercial Acceptance Corporation as "Commerce Acceptance Company, Inc."

IN WITNESS WHEREOF, the undersigned has hereby executed this instrument.

THE FULINE CORPORATION

By \_\_\_\_\_ A. A. GRIFFITH



Appendix C (continued)

The foregoing instrument is hereby acknowledged to be a true and correct statement of the facts and the intentions of the parties as recited therein.

COMMERCIAL ACCEPTANCE CORPORATION

By D. C. HUTCHINSON, V.Pres.

COMMERCE ACCEPTANCE COMPANY, INC.

By D. C. HUTCHINSON, V.Pres.





## UNITED STATES COURT OF APPEALS

## FOR THE NINTH CIRCUIT

ERLE G. SWANSON and  
HELEN F. SWANSON,  
husband and wife,

Appellants,

v.

COMMERCIAL ACCEPTANCE  
CORPORATION, a Missouri  
corporation,

Appellee.

FILED

SEP 22 1966

WM. B. LISK CLERK

APPELLEE'S BRIEF

Appeal from the United States District Court for the  
District of Oregon

THE HONORABLE WILLIAM G. EAST, Judge

BORDEN F. BECK, JR.  
BLACK & APICELLA  
400 Selling Building  
Portland, Oregon 97205

Attorneys for Appellee

CERTIFIED A TRUE COPY

By Borden F. Beck Jr.  
Of Attorneys for Appellee



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UNITED STATES COURT OF APPEALS  
FOR THE NINTH CIRCUIT

---

ERLE G. SWANSON and  
HELEN F. SWANSON,  
husband and wife,

Appellants,

7.

COMMERCIAL ACCEPTANCE  
CORPORATION, a Missouri  
corporation,

Appellee.

---

APPELLEE'S BRIEF

---

Appeal from the United States District Court for the  
District of Oregon

THE HONORABLE WILLIAM G. EAST, Judge.

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STATEMENT OF JURISDICTION

Appellee accepts appellants' statement of jurisdiction.

SUPPLEMENTAL STATEMENT OF THE CASE

Appellee generally concurs in the statement of the facts  
of this case as presented by appellants in their brief; however,  
certain findings of fact by the Court, and facts stipulated by  
the parties, were omitted in appellants' statement which are of  
paramount importance to the final determination of the case, and





are, therefore, included hereinbelow.

The Fuline Corporation is a totally separate and distinct corporate entity from the appellee, with neither corporation owning any interest in the other, and there does not now exist, nor has there existed, any common director or officer of the two corporations (R. 52, 89). Prior purchases of negotiable paper by appellee from Fuline had been in the regular course of business and on a transaction-by-transaction basis (R. 63, 82). Prior to the time appellants and Fuline agreed upon the purchase and sale of the equipment involved herein, appellee had no knowledge of the representations which Fuline may have made to induce the purchase of said equipment by appellants (R. 64, 82). Fuline's negotiations for and decision to sell equipment to the appellants, and Fuline's acceptance of the purchase price notes and mortgages, together with the other terms and conditions of the purchase and sale, were made solely by Fuline upon its own responsibility and were not subject in any respect to the control of the appellee (R. 82, 90).

At the time said sales of equipment from Fuline to appellants were consummated and said notes and chattel mortgages were executed by appellants and delivered to Fuline, Fuline could have transferred said notes and mortgages to any person whomsoever as determined by Fuline in its sole discretion and Fuline was not required or obligated to sell or transfer said notes and chattel mortgages to appellee (R. 64, 83). After appellants and Fuline agreed on May 1, 1962, to the purchase and sale of said equipment and before June 13, 1962, when Fuline sold to appellee the said note and chattel mortgage dated June 12, 1962, Fuline was dealing and negotiating with another finance company, Northern Finance Corporation, regarding the purchase of said commercial paper of appellants (R. 65, 83 and Exs. 73, 110 and 111). Said Northern





Finance Corporation was a distinct corporate entity from appellee (R. 65, 83 and Ex. 73 - p. 4, item 14).

At no time prior to the agreement between Fuline and the appellants for the purchase and sale of the equipment involved herein, and at no time prior to the purchase of the notes and chattel mortgages in question by appellee from Fuline, did appellee's counsel, consult with, or have any direct dealings with the appellants or in any way make any representation to appellants regarding said equipment (R. 52, 90).

The promissory notes in question were made payable at the address of Fuline, and not that of appellee (R. 52 - Item 24). The notes and mortgages in question were delivered by Fuline to the actual possession of appellee which purchased the said notes and mortgages from Fuline by giving value therefor to Fuline at the time of their respective purchase by appellee which has, at all times since such respective purchases and deliveries of said notes and mortgages to appellee, been and is in possession of said notes and mortgages (R. 47, 48, 89).

Commerce Acceptance Company, Inc. (hereinbelow sometimes referred to as "Commerce") was the nominal original endorsee of the notes here in question. It is the holder of 100% of the stock of the appellee, and while Commerce and appellee have a common officer, they are separate legal entities engaged in separate businesses. At no time did Commerce (a) purchase or agree to purchase from Fuline the notes and chattel mortgages in question, (b) pay or give, or agree to pay or give, to Fuline any consideration whatsoever in payment for said notes and chattel mortgages, or (c) receive possession of said notes and chattel mortgages. At no time did appellants, Fuline, appellee or Commerce contemplate or intend that the notes and mortgages were to be purchased or





transferred to Commerce. The appellants at all times made payments directly to appellee, and continued to make those payments to appellee of the installments due under the notes after appellants became aware of the matters upon which they base their contention that the machines were faultily constructed (R. 48, 49, 51, 90, 91).

Each of the said promissory notes was endorsed by Fuline to appellee by execution of the writing on the reverse side of each of said respective notes, and said endorsements inadvertently misspelled and wrongly designated the name of appellee, Commercial Acceptance Corporation, as "Commerce Acceptance Company, Inc." (R. 64, 83). Each of the said chattel mortgages was assigned by Fuline to appellee by the execution of a writing on the second page of each of said chattel mortgages below the word "ASSIGNMENT" and said assignments inadvertently misspelled and wrongly designated the name of appellee, Commercial Acceptance Corporation, as "Commerce Acceptance Company, Inc." (R. 64, 83). The blank spaces in the forms of chattel mortgages and forms of notes which were used by Fuline and appellants in this transaction were filled in by Fuline and/or appellants and not by appellee (R. 64, 83). When appellee purchased said notes and mortgages from Fuline, Fuline executed the "Assignment" attached to each said chattel mortgage and the endorsement on the back of each said note with the intention and understanding of Fuline and appellee that the assignee of said chattel mortgages, and the endorsee of said promissory notes, was appellee (R. 65, 83).

As stated by appellants in their brief, the trial court concluded as a matter of fact that the naming and designating of Commerce Acceptance Company, Inc., was due to the mutual mistake and inadvertence of Fuline and appellee, and it was the mutual understanding and intention of the appellants, appellee and Fuline





that if notes were sold to appellee they were to be transferred to it by proper endorsements and assignments by Fuline (R. 92).

In addition, the trial court concluded as a matter of fact that Commerce Acceptance Company, Inc., never had any interest or claim to the notes or their securing mortgages, and that the mistake and inadvertent endorsement of the notes and transfer of the mortgages by Fuline to Commerce has not caused any change of appellants' position as maker, or otherwise worked to their additional loss or prejudice (R. 92).

#### STATUTES INVOLVED

The four states with any possible connection to the transactions involved herein, and to the issue presently before the court are Missouri (the place of endorsement and delivery of the notes by Fuline to Commercial Acceptance), Washington (the place of execution by appellants of the notes and chattel mortgages and the location of some of the property subject to the chattel mortgages), Oregon (the place where the action was brought and the location of some of the property subject to the chattel mortgages), and Kansas (the place where the notes were made payable, and the place of inadvertent endorsement to Commerce).

At all times relevant to this action, the Uniform Negotiable Instruments Law (hereinafter referred to as the "N.I.L.") was in effect (with minor modifications) in all four of said states and thus any possible question of conflict of laws is minimal. The court below declined to deal with any conflicts issues for this reason (R.93). Set forth in Appendix "A" are the provisions of the N.I.L. which are relevant to this matter with citations given to those provisions (or modifications thereof) as codified in





Missouri, Washington, Oregon and Kansas.

## SUMMARY OF ARGUMENT

I. The trial court's findings and conclusions of fact should not be disturbed since they are supported by the record and are not clearly erroneous.

II. The Negotiable Instruments Law is applicable to this transaction and appellee took appellants' notes in "good faith" so as to become a holder in due course and thereby entitled to recover from appellants. This conclusion is fully supported by the facts of this case, the weight of well reasoned judicial authority and by the recognized public policy underlying the N.I.L.

III. Since appellee purchased appellants' notes from Fuline for value and took possession and delivery thereof from Fuline, and since it was understood and intended that the notes were endorsed by Fuline to appellee, appellee's status as a holder in due course is not defeated by the fact that the printed text of the endorsement on each of the notes shows the name of the endorsee to be "Commerce Acceptance Company, Inc." Such designation of the endorsee was inadvertent and expressly covered by N.I.L. Sections 43 or 9. The sole authority relied upon by appellants in support of their position that "there was no proper endorsement" to appellee, is inapplicable upon the facts and is based upon Section 42 of the N.I.L. which has no applicability whatsoever to the present case.

## ARGUMENT

I. SINCE THE TRIAL COURT'S FINDINGS OF FACT WERE FULLY SUPPORTED BY THE RECORD AND WERE NOT CLEARLY ERRONEOUS, THE TRIAL COURT'S FINDINGS OF FACT SHOULD NOT BE DISTURBED.

Inasmuch as the arguments made in appellants' brief depend





largely upon appellants' attempts to ignore, or overrule, the express findings of fact of the trial court, it becomes appropriate to determine the scope of this court's review.

The findings of fact of a trial judge where an action is tried without a jury will not be set aside unless clearly erroneous. Rule 52(a), Federal Rules of Civil Procedure (28 U.S.C.)

While at one time in the past, the cases were in considerable confusion with respect to whether Rule 52(a) applied where the trial court's findings were based on undisputed facts, this court settled the question in Lundgren v. Freeman, 307 F.2d 104 (9th Cir. 1962), in which it was held that the Ninth Circuit would follow the reasoning of the Supreme Court in Commissioner of Internal Revenue v. Duberstein, 363 U.S. 278, 80 S.Ct. 1190, 4 L. Ed. 2d 1218 (1960). Thus, it is now settled that the findings of a trial court will not be disturbed unless clearly erroneous, even where those findings are based on undisputed testimony, and that the scope of review is limited to the application of the law. See also United States v. First Security Bank, 334 F.2d 120 (9th Cir. 1964); Stauffer Laboratories, Inc. v. Federal Trade Commission, 343 F.2d 75 (9th Cir. 1965); Azevendo v. Commissioner of Internal Revenue, 246 F.2d 196 (9th Cir. 1957); Randall Foundation, Inc. v. Riddell, 244 F.2d 803 (9th Cir. 1957).

Applying these decisions and Rule 52(a) to our case, this court is bound by the findings and conclusions of fact in the court below and those findings and conclusions of fact should not be overturned unless they are clearly erroneous.

As will be seen below, this limitation on the scope of review of this court becomes relevant on both major points advanced in appellants' brief. Thus appellants admit appellee's "good faith" in the transactions in question, but they then proceed to assert that appellee actively participated in the transaction between Fuline





and appellants in due course. This assertion of appellants is directly contrary to the trial court's conclusion that appellee (a) did not actively participate in the transaction between Fuline and appellants so as to become a party to their transaction and (b) did not otherwise lack "good faith," so as to defeat appellee's status as a holder in due course (R. 97). These conclusions of fact were amply supported by the evidence and by the trial court's findings of fact. See Supplemental Statement of The Case hereinabove.

Similarly, in their argument that the original endorsement by Fuline was defective so as to defeat appellee's status as a holder in due course, appellants are in effect asking this court to ignore or overrule the express findings and conclusions of fact of the trial court as to (a) the intentions of the parties, (b) the mutual mistake and inadvertence when the original endorsement was made, and (c) the fact that appellee's name as endorsee was inadvertently misspelled and wrongly designated. (See Supplemental Statement of the Case hereinabove and R. 92, 64, 83.)

Similarly, in asserting on page 18 of their brief that, prior to its purchase of the commercial paper in question, appellee had a "contractual duty" to purchase such paper, appellants ignore the fact that no such contractual duty was found by the trial court and also ignore the findings and conclusions of fact by the trial court to the effect that prior to the actual sale of the paper to appellee Fuline had no obligation to sell the paper to appellee (R. 82, 64).

It is submitted, that this case may be easily resolved in favor of appellee by applying to appellants' argument the established rule limiting the scope of this court's review of the trial court's findings and conclusions of fact. Since those findings and conclusions of fact are not clearly erroneous, they





must stand.

II. THE NEGOTIABLE INSTRUMENTS LAW APPLIES TO THIS TRANSACTION. APPELLEE TOOK THE NOTES IN GOOD FAITH AND IS A HOLDER IN DUE COURSE ENTITLED TO RECOVER FROM APPELLANTS.

Appellants' argument that the Negotiable Instruments Law (hereinafter sometimes referred to as the "N.I.L.") is inapplicable to this transaction is entirely erroneous and completely unsupported. Of the seven cases cited by appellants to support their argument that the N.I.L. doesn't apply, four of the cases explicitly involved the application of the N.I.L. and each was decided on the respective court's own interpretation of the N.I.L. as applied to the facts before it. Commercial Credit Corporation v. Orange County Machine Works, 34 Cal. 2d 766, 214 P.2d 819 (1950); Mutual Finance Company v. Martin, (Fla.) 63 So. 2d 649 (1953); United States v. Klatt, 135 F. Supp. 648 (S.D. Cal. 1955); International Finance Corporation v. Rieger, \_\_\_\_ Minn. \_\_\_\_, 137 N.W. 2d 172 (1965). Two of the other cases cited by appellants are only brief decisions which indicate, at least by implication, that the "good faith" concept under the N.I.L. was being applied. Commercial Credit Co. v. Childs, 199 Ark. 1073, 137 S.W. 2d 260 (1940); Industrial Credit Company v. Mike Bradford & Co., Inc., (Fla.), 177 So. 2d 878 (1965). The other case cited by appellants was not concerned with the N.I.L. because it involved a usurious contract which was void at its inception under the Arkansas law relating to usury. Schuck v. Murdock Acceptance Corporation, 220 Ark. 56, 247 S.W. 2d 1 (1952).

In arguing that "the N.I.L. doesn't apply," appellants indicate that they rely heavily upon their assertion of the fact (an assertion contrary to the specific conclusion of the trial court) that appellee actively and directly participated in the transaction between appellants and Fuline. Even a cursory analysis





of the cases relied upon by appellants, shows that this is really an argument that appellee did not act in "good faith" under the applicable rules of the N.I.L. Since, however, the trial court specifically found that appellee did act in "good faith" under the applicable standards of the N.I.L. (R. 97, 63, 82), and since appellants admit in their brief herein (p. 9) that they "are making no claim here, nor did they make any claim in the lower court that there was any lack of good faith on the part of the appellee," it has apparently become necessary for appellants to ignore the fact that the issue they attempt to raise is one of "good faith" under the N.I.L. and not a point of fact or law outside the N.I.L.

We submitted that the N.I.L. does apply to the transactions involved herein and that not only did appellants not sustain their burden to prove that appellee did not take the notes in "good faith," but also the facts and the applicable law clearly support a finding that appellee did take the notes in good faith. Appellee's position as a holder in due course is further supported by the strong public policy behind the N.I.L. favoring a free flow of honest credit to honest businesses.

There have been many cases decided in this country involving the question of the status of financial institutions as holders in due course of commercial paper purchased from sellers of industrial equipment and consumer goods. When the facts and holdings in these cases are closely analyzed, it is clear that the weight of authority and the better reasoned authority supports the position of appellee as a holder in due course under the facts involved herein. Since the courts have examined various factors in their decisions which are present here, we shall attempt to do the same.

First, it should be recognized that the general rule under the N.I.L. is that a holder in due course is not subject to





the defense of misrepresentation, failure of consideration or breach of warranty. United States v. Bryant, 58 F. Supp. 663 (S.D. Fla. 1945), aff'd 157 F.2d 767 (5th Cir. 1946); Advance-Rumley Thresher Co. v. West, 108 Kan. 875, 196 Pac. 1061 (1921); United States National Bank v. Floss, 38 Or. 68, 62 Pac. 751 (1900); Clarinda Trust & Savings Bank v. Doty, 83 Or. 214, 163 Pac. 418 (1917); Intges v. People's Finance & Trust Co., (Tex. Civ. App.) 44 S.W. 2d 1028 (1931); Yakima Finance Corp. v. Mullins, 138 Wash. 553, 245 Pac. 5 (1926).

The fact that a note and chattel mortgage (or other security instrument) are executed concurrently or are on the same piece of paper (and especially where, as is the case here, the note can be detached from the mortgage), has repeatedly been held not to defeat a holder's status as a holder in due course. Implement Credit Corp. v. Elsinger, 268 Wis. 143, 66 N.W. 2d 657 (1954), reh. den. 67 N.W. 2d 873 (1955); National Bond & Investment Company v. Lanners, 253 Ill. App. 262 (1929); Morgan v. Mulcahey, (Mo.) 298 S.W. 242 (1927); Commercial Credit Corporation v. Orange County Machine Works, 34 Cal. 2d 766, 214 P.2d 819 (1950); Mutual Finance Co. v. Martin, (Fla.) 63 So. 2d 649 (1953); White System of New Orleans, Inc. v. Barganier, (La.) 172 So. 2d 741 (1965).

The fact that appellee received a copy of appellants' financial statement for purposes of reviewing their credit in no way defeats the status of appellee as a holder in due course. Thus, the courts have generally held a transferee's investigation of a chattel purchaser's financial standing not only does not defeat a transferee's holder in due course status, but it also supports a finding of a transferee's good faith in the transaction. Commercial Credit Corporation v. Smith, 143 Misc. 478, 256 N.Y.S. 759 (1932); Intges v. People's Finance & Trust Co. (Tex. Civ. App.)





44 S.W. 2d 1028 (1931); White System of New Orleans, Inc. v. Barganier, (La.) 172 So. 2d 741 (1965). Had appellee not approved appellants' credit in advance, appellants would probably now be asserting that such failure would defeat appellee's status as a holder in due course, citing the Intges decision as authority.

The fact that a transferee has furnished a seller with forms of instruments for execution by a chattel purchaser has repeatedly been treated by the courts as not preventing a transferee from being a holder in due course. Implement Credit Corporation v. Elsinger, 268 Wis. 143, 66 N.W. 2d 657 (1954), reh. den. 67 N.W. 2d 873 (1955); White System of New Orleans, Inc. v. Hall, 219 La. 440, 53 So. 2d 227 (1951); Mann v. Leasko, 179 Cal. App. 2d 692, 4 Cal. Rptr. 124 (1960); James Talcott, Inc. v. Shulman, 82 N.J. Super. 438, 198 A.2d 98 (1964); White System of New Orleans, Inc. v. Barganier, (La.) 172 So. 2d 741 (1965).

The fact that a transferor and transferee have dealt together previously and either have a regular financing arrangement or have dealt together before on a transaction-by-transaction basis have been recognized by the courts as not depriving the transferor of its holder in due course status with respect to commercial paper purchased by it from the transferee. Implement Credit Corp. v. Elsinger, 268 Wis. 143, 66 N.W. 2d 657 (1954), reh. den. 67 N.W. 2d 873 (1955); Mann v. Leasko, 179 Cal. App. 2d 692, 4 Cal. Rptr. 124 (1960); Singer v. National Bond & Investment Co., 218 Ala. 375, 118 So. 561 (1928); Mutual Finance Corporation v. Dickerson, 123 N.J.L. 62, 7 A.2d 859 (1938); New Jersey Mortgage & Investment Corp. v. Calvetti, 68 N.J. Super. 18, 171 A.2d 321 (1961); International Finance Co. v. Magilansky, 105 Pa. Super. 309, 161 Atl. 613 (1932); Commercial Credit Corporation v. Smith, 143 Misc. 478, 256 N.Y.S. 759 (1932). The fact that appellee purchased a great deal of





commercial paper in the ordinary course of its business and that only a relatively small portion of such purchases was made from Fuline, further supports appellee's "good faith" and its status as a holder in due course with respect to appellants' paper. Cf. Barnard, Phillips Factors, Inc. v. Kaplan Silk Corporation, 28 N.Y.S. 2d 696 (1939), aff'd 28 N.Y.S. 2d 699 (1941).

The fact that a finance company has agreed with the seller, prior to the making of a sale that it would finance the transaction by purchasing a note of the purchasers, does not prevent the purchaser of the notes as being regarded as a holder in due course. White System of New Orleans, Inc. v. Hall, 219 La. 440, 53 So. 2d 227 (1951); Morgan v. Mulcahey, (Mo.) 298 S.W. 242 (1927); National Bond & Investment Co. v. Miller, (Mo.) 76 S.W. 2d 703 (1934). In James Talcott, Inc. v. Shulman, 82 N.J. Super. 438, 198 A.2d 98 (1964), a very well reasoned opinion holds that lack of good faith to defeat holder in due course status of a finance company is not demonstrated merely because a finance company entered into an arrangement with a manufacturer's agent whereby the finance company subsequently purchased from the manufacturer's agent commercial paper of third parties executed after the discounting arrangement was entered into. A close analysis of New Jersey Mortgage and Investment Corp. v. Calvetti, 68 N.J. Super. 18, 171 A.2d 321, 327 (1961) also shows that the court there considered that the date the ultimate purchaser of notes was first approached as to purchase was "patently irrelevant" to the question of notice and the purchaser's "bad faith." Another case in which a finance company's agreement to purchase commercial paper prior to the execution and giving thereof did not defeat the finance company's status as a holder in due course who purchased the paper in good faith is Universal C.I.T. Credit Corporation v. Alker, 239 La. 1057, 121 So. 2d 78 (1960). See, also, Singer v. National Bond &





Investment Co., 218 Ala. 375, 118 So. 561, 562 (1928).

At page 18 of their brief before this court, appellants state, as though it were a fact (which it is not), that appellee had a "contractual duty and obligation" to purchase the notes in question. No such contention was made by appellants in the Pre-Trial Order and the uncontroverted testimony and the finding of the trial court was that Fuline, prior to the actual transfer of the notes to appellee for value, had no obligation to sell the notes to appellee. It is important to recognize that appellants' reiterated statements to the effect that appellee was "committed to purchase" appellants' paper are not supported by the record, by the trial court's findings, or by applicable law. The most that can possibly be made of the facts of this case is that appellee may have made an oral offer to buy the paper before it was written but such an offer would not have been a contract until it was accepted and it clearly was not accepted until long after appellants and Fuline had entered into their sales transaction. Further, even if appellee had in some way been committed to purchase appellants' first note, such commitment would appear to have been terminated by Fuline's entering into negotiations with Northern Finance Corporation for the purchase and sale of said note (R. 65, 83 and Exs. 73, 110 and 111). In all events, the above cited cases make it clear that even if appellee had been legally obligated to purchase said notes, such fact would not be a proper basis for depriving appellee of its holder in due course status.

In those cases where transferors have been found not to be holders in due course of commercial paper purchased from dealers, there has been most frequently involved situations where the dealer had committed some fraud upon his buyer with respect to the sale of





property (usually consumer goods) and where the transferor has some actual, or constructive, knowledge of the fraud. In the present case the claim for rescission is based primarily on breach of warranty and there is no serious claim of fraud against Fuline. Further, there is no contention or testimony to indicate that appellee had, at the time it purchased the notes, any knowledge of (or had participated in) any breach of warranty or any fraud by Fuline. In fact, the testimony and findings of the trial court are to the contrary (R. 52, 64, 82). Under circumstances where the transferor has not had knowledge of, and has not participated in, any fraud of the seller, or has not engaged in sharp practices itself with respect to the seller, the courts are not readily inclined to deprive a transferee of his holder in due course status. See, e.g., Morgan v. Mulcahey, (Mo.) 298 S.W. 242 (1927); Commercial Credit Corporation v. Smith, 143 Misc. 478, 256 N.Y.S. 759 (1932); Clarinda Trust & Savings Bank v. Doty, 83 Or. 214, 163 Pac. 418 (1917); Wilson v. Gorden, (D.C. Mun. App.), 91 A.2d 329 (1952); New Jersey Mortgage and Investment Corp. v. Calvetti, 68 N.J. Super. 18, 171 A.2d 321 (1961). As stated in Mann v. Leasko, 179 Cal. App. 2d 692, 4 Cal. Rptr. 124, 126 (1960):

"It has been uniformly held that the requirement of 'good faith,' imposed by the Negotiable Instruments Law, generally means that the transaction was honestly conceived and consummated without collusion, fraud, knowledge of fraud, or intent to assist in the perpetration of fraud."

All of the cases which appellants cite in support of their position are not only overcome by the weight of reasoned authority contrary to appellants' position but, as is shown below, said cases cited by appellants are also distinguishable in other ways to make them inapplicable.





Contrary to appellants' erroneous assertion on page 12 of their brief, the facts involved in Mutual Finance Company v. Martin, (Fla.) 63 So. 2d 649 (1953), are distinguishable from our case in many important regards including the following:

(1) In Mutual Finance the finance company's office was designated in the note as the place of payment. In our case, Fuline's office was designated in the note as the place of payment.

(2) In Mutual Finance the finance company investigated the credit of the buyer one day, the deal was closed the next day, and the notes were transferred on the following day. In our case, the appellants' credit was reviewed in late April, the contract was entered into between appellants and Fuline in early May and the notes were not sold and endorsed to appellee until June.

(3) In Mutual Finance the seller was a substantial shareholder of the finance company, and seller represented that the finance company would finance the transaction. In our case, there was no connection between appellee and Fuline and no representations were made by, or for, appellee of the kind made in Mutual Finance.

(4) In Mutual Finance the court speaks of the finance company counseling and aiding the seller from the inception of the transaction. In our case, no such counsel or aid was given, and, in fact, Fuline was negotiating with another finance company to purchase appellants' paper. Further, appellee had no knowledge of any representations of Fuline to appellants.

(5) In Mutual Finance the seller was dealing only with one finance company with all its paper, and in our case, appellants have shown no such fact to exist and, in fact, after having talked





to appellee, Fuline actually negotiated to sell appellants' paper to Northern Finance Corporation thereby relieving appellee of any obligation to purchase appellants' paper. A similar distinction has been made of the Mutual Finance decision in Citizens and Southern National Bank v. Stepp, 126 F. Supp. 744 (N.D. Fla. 1954).

(6) Mutual Finance involved the sale of consumer goods and the court showed great concern for consumers. In our case, the sales involved were large sales of equipment to a businessman and one whom the courts are less inclined to protect at the expense of other innocent parties.

(7) In Mutual Finance the court was concerned with the problem of how to protect against "unscrupulous dealers." In our case, there is no suggestion that Fuline was "unscrupulous" and, in fact, the Exhibits on file show the great amount of cooperation given appellants by Fuline. Further, Fuline contended in the Pre-Trial Order that, shortly before they first claimed the right to rescind, appellants were considering buying more equipment from Fuline and requesting refinancing of old equipment (R. 61).

(8) In Mutual Finance the name of the finance company is shown prominently at the top and throughout the face of the contract and note. In our case, the name of appellee is not in the face of the note or mortgage (although its misdesignated name "Commerce Acceptance Company, Inc." is set forth without undue prominence in the printed endorsement to the note and assignment to the mortgage).

The case of Schuck v. Murdock Acceptance Corp., 220 Ark. 56, 247 S.W. 2d 1 (1952) (cited at page 13 of appellants' brief) is completely inapplicable to our case. In Schuck the issue was





usury and the N.I.L. was not applicable because a usurious contract is void in Arkansas. Further the dealer in Schuck was found to be the agent of the finance company (the dealer investigated the credit; the finance company gave the dealer a bonus each year; and the finance company paid the dealer for his services in the transaction). The appellants in our case are not contending that Fuline was the agent of appellee.

The facts involved in Commercial Credit Corporation v. Orange County Machine Works, 34 Cal. 2d 766, 214 P.2d 819 (1950) (cited at page 11 of appellants' brief) are distinguishable from the present case in several important regards, including the following:

(1) In Orange County Machine Works the finance company knew at the time it purchased the buyer's notes, that the equipment involved did not belong to the dealer and had not been delivered to the buyer. This was obviously critical to the court because the manufacturer never delivered the equipment to the buyer when the dealer's check bounced. Such critical facts are not involved in our case.

(2) In Orange County Machine Works the court held that the finance company "knew all of the details of the transaction" and that "the finance company was a moving force in the transaction from its very inception." In our case, it is clear that appellee did not know all of the details of the transaction between appellants and Fuline and that appellee was not "a moving force in the transaction from its inception." In our case, almost six weeks transpired from the time appellee was contacted until appellee purchased the notes and during that time (and without any knowledge





of or guidance by appellee), Fuline and appellants entered into their various contractual arrangements. Fuline prepared and executed the commercial documents and Fuline conducted negotiations with Northern Finance Corporation to purchase the appellants' paper.

In citing United States v. Klatt, 135 F. Supp. 648 (S.D. Cal. 1955), at page 14 of their brief in support of their position, appellants disregard the critical facts which caused the court to hold that the Bank of America was not a holder in due course in that case. The actual holding of the case was that the plaintiff to whom a note had been assigned by the Bank of America after default, was not a holder in due course because it took the note after maturity and with notice of defects and that the Bank, through which plaintiff derived title, was also not a holder in due course. In concluding that the Bank was not a holder in due course, the key fact obviously is that the Bank had notice that the loan and the note evidencing the debt were subject to a requirement that an executed completion certificate was required which the court held was not received. What the relationship of the Bank was to the "entire transaction" and to the blatant fraud involved, is not fully shown, but without such a showing, we submit that the Klatt case is not a relevant to the facts of our case. For a similar analysis of the Klatt case by the trial court, see R. 95, 96.

The case of Commercial Credit Co. v. Childs, 199 Ark. 1073, 137 S.W. 2d 260 (1940) cited at page 13 of appellants' brief is distinguishable from our case in the following regards:

- (1) In Childs the court merely decided that there was





enough evidence for the jury to have reached its decision (and the court did not analyze closely the underlying legal issue with which we are concerned).

(2) The Childs case involved extensive fraud by an automobile dealer upon a consumer (apparently with the accompanying sympathy of judge and jury without consideration of the public policy of the N.I.L.).

(3) The finance company prepared the note in Childs.

(4) The court, in Childs, found that the finance company had put the dealer in position to procure the consumer's signature through fraudulent misrepresentation.

Appellants cite two recent cases which they contend support their position that the N.I.L. is not applicable. Neither is persuasive here, and in fact, dicta in one of them weighs strongly in favor of the appellee, when applied to the facts of this case.

Thus, in International Finance Corporation v. Rieger, Minn., 137 N.W. 2d 172 (1965), cited at page 13 of appellants' brief, the court held that the plaintiff finance company had actual knowledge from the inception of the transaction that the liability of the maker of the promissory note sued on was conditional upon the performance of the contract by the payee, and in addition had knowledge of the breach. In our case, there is no contention by appellants that the notes were conditional, and such is clearly not the case. Even if it were, the agreed facts are that Fuline dealt with appellants independently of appellee at all times, and there is no claim or showing of any actual or constructive knowledge by appellee of liability on the notes being contingent on conditions to be performed by Fuline.





In addition, there was in International Finance a forged certificate of installation and delivery, which the court viewed as critical to the "good faith" issue. The court was careful to point out that it was these facts which distinguished the case from Implement Credit Corporation v. Elsinger, 268 Wis. 143, 66 N.W. 2d 657 (1954), reh. den. 67 N.W. 2d 873 (1955) and other cases relied upon by appellee. The following statement of the court, at 137 N.W. 2d 178, clearly indicates the distinction between the issues involved both in that case and here:

"We recognize that other decisions hold that where the assignee of a note and conditional sales contract has knowledge prior to purchase that the contract is for goods warranted or that the consideration is future or contingent, this does not prevent the assignee from becoming a holder in due course, if he has no knowledge of the breach or nonperformance of the contract provisions prior to his acquisition of the note and contract. /Citing Elsinger and other cases/ These decisions for the most part have reference to situations where an assignee of a note has knowledge of the executory consideration for it rather than knowledge that conditions are to be performed by the payee before liability attaches to the maker. /Citing cases./ Further, none of these involves a forged certificate of delivery and installation, as does the instant case, in which a forged certificate, as indicated, could not have eliminated the condition upon which the defendants' liability depended." (Emphasis supplied.)

From the foregoing, it can be seen that the International Finance case not only does not support appellants' position, but it also points up clearly the factual distinction between the cases relied upon by appellants and the facts here. It is this distinction which must cause appellants' argument to fail.

The case of Industrial Credit Company v. Mike Bradford & Co., Inc., (Fla.) 177 So.2d 878 (1965), cited at page 14 of appellants' brief, involves a number of facts not present here. Thus, in





Bradford the commercial paper was executed and assigned on the same day. Further, the paper was signed in the finance company's office and witnessed by the finance company's employees. Although the decision does not make this clear, it appears that the finance company and the debtor were dealing together directly at the time of the execution and assignment of the paper. These facts are completely different from the facts in our case where appellants and appellee never dealt directly with one another, where the paper was not executed in appellee's office, and where the paper was not sold to appellee until more than a month after the equipment was sold to appellants and the first mortgage executed.

Further, we submit that the decision in Bradford is unreliable because it is poorly reasoned and because it relies heavily upon other decisions which are not carefully analyzed as to the specific facts involved therein. The Bradford decision illustrates well that this is an area where a careless reliance on quoted excerpts from other court decisions is not an adequate substitute for a careful analysis of (a) all the facts in the case to be decided, (b) all of the facts behind, and the reasoning of, prior decisions, (c) the law involved and (d) the public policy behind that law.

A study of the cases in this area will show that a holder will not be deprived of holder in due course status because of a "combination of circumstances" by themselves insufficient to constitute bad faith, but rather, holder in due course status will be defeated only where there is fraud, or the holder has actively and directly participated as a party in the transaction between the maker and the payee, or has knowledge of





conditional liability on the part of the maker, which in effect constitutes knowledge of a defense which would keep the holder from being a holder in due course in any event under Section 52 of the N.I.L.

Appellants' case really boils down to an argument that appellee cannot be a holder in due course because it did not act in good faith. Appellants argue that they interpret the facts to be that appellee "actively participated" in the transaction between appellants and Fuline, and that this keeps appellee from being a holder in due course (i.e., that appellee was not acting in "good faith" under the N.I.L.). Appellants admit that the individual facts (even as interpreted by appellants) would not constitute "active participation" or "bad faith" so as to defeat appellee's position as a holder in due course. Appellants do contend, however, that the cases cited by them support their position that all of the facts considered together do constitute "active participation" (i.e., "bad faith") which will defeat appellee's position as a holder in due course.

The trouble with appellants' argument is that it is based upon (a) a distorted view of the facts of this case, (b) an inadequate analysis of the facts and reasoning of the applicable cases, and (c) a failure to realize that appellants are arguing that appellee was acting in "bad faith" under the standards of the N.I.L. What appellants seem to be saying is that appellee by a combination of circumstances (as interpreted by appellants) become a party to the original transaction between appellants and Fuline so as to defeat appellee's status as a holder in due course under the N.I.L. In so arguing, appellants fail to recognize that the





trial court specifically found that appellee "did not actively participate in the transaction" between appellants and Fuline "to the extent that it became a party to their transaction" and that appellee "did not otherwise lack 'good faith' in taking the notes" as required by the N.I.L. (R. 97).

Fundamentally, by their interpretation of the facts and their contentions as to the applicable law, the appellants are asking the court to make a ruling which would completely defeat the public policy behind the N.I.L. of "free flowing credit." This public policy has been continued by the widespread adoption of the Uniform Commercial Code. Appellants could have financed their purchase of machines by borrowing money from a bank, secured by notes and chattel mortgages (and perhaps by a guaranty of Fuline). In such a circumstance, the lender would clearly have been a holder in due course. Here appellants were able to purchase equipment because someone (namely appellee - but it could have been anyone) was willing to purchase appellants' notes and chattel mortgages. From a realistic point of view, the transaction was financed to the benefit of appellants by an independent third party which purchased appellants' paper in good faith, and the result in this case should be no different than if the paper had been given by appellants directly to a bank in exchange for a loan. No fraud is involved and no shady relationship exists between Fuline and appellee. To hold, under the circumstances of this case, that a financial institution cannot purchase commercial paper as a holder in due course from a dealer, would be to overturn the public policy of the N.I.L. that supports free flowing credit and would cause immense





difficulty to legitimate businesses (and especially small businesses) who seek to buy and sell goods on credit in the market place. As the court stated in Implement Credit Corporation v. Elsinger, 268 Wis. 143, 66 N.W. 2d, 657, 666 (1954):

"We must take cognizance of the fact that a very large percentage of the sales of motor vehicles, farm machinery, electrical appliances, furnaces, and similar articles are made by dealers to their customers on credit, whereby the purchaser makes a down payment in cash or trade-in and gives his negotiable note for the balance secured by a conditional sales contract or chattel mortgage. These notes usually provide for monthly installment payments extending over fairly long periods of time. Most dealers have not the capital to carry such notes and at the same time replenish their inventory stock so it is customary for them to discount such notes with a finance company or bank. A very considerable segment of our economy is dependent for its continued prosperity upon such free flow of credit, and anything which delays or impedes such process may well be regarded as against public interest."

Or as said in Cotton v. John Deere Plow Co., 246 Ala. 36, 18 So. 2d 727, 729 (1944) where an endorsee of a note was held to be a holder in due course in the face of a claimed breach of warranty:

"The reason for the rule sustaining negotiability under circumstances as here is quite obvious. A substantial part of the credit business of the country is carried on with money raised by the discount of notes given upon such executory agreements or warranties, and to allow such a defense would destroy all confidence in such notes as negotiable paper, resulting in the paralysis of this character of business.

"The opinion of Baker State Bank v. Grant, 54 Mont. 7, 166 P. 27, 28 (1917), well expresses the thesis: 'It has often been said that a negotiable promissory note is a courier without luggage whose face is its own passport. To such extent do notes of this character enter into and form a substantial part of the very life of the commercial world that the law has always been solicitous to exclude any rules calculated to hinder their free circulation





and exchange. By the act of executing such an instrument, the maker is held to have intended that it may enter the channels of trade and pass from hand to hand unincumbered by any defense not known to exist when the transfer is made.'"

We point out that our case does not in any way resemble the situation where a housewife has been fraudulently induced to purchase a washing machine without a motor by an appliance company who was assisted in selling the machine by its subsidiary finance company and which participated in the selling negotiations and in the seller's fraud to the extent that the finance company cannot be a holder in due course of the housewife's note for the purchase price. We are dealing with a large transaction between independent businessmen operating under the long established rules of the N.I.L. and with the expectations of the commercial community which have relied on those rules.

Looking at our case, the "original transaction" was the sale of the equipment between Fuline and appellants and the negotiation of their license agreement with one another. Obviously appellee did not have direct participation in this transaction and it certainly did not deal with appellants at any time prior to purchase of the notes.

Appellants would try to have us believe that approval given to Fuline of appellants' credit and an offer to Fuline to purchase appellants' commercial paper constituted active and direct participation throughout the original transaction. We submit this is in error and not only misreads even the judicial decisions relied upon by appellants, but also ignores the great weight of authority set forth in the decisions they don't agree with.



The applicable public policy is dealt with at page 114 of Braucher and Sutherland, Commercial Transactions (2nd Ed. 1958), which states:

"The concept of the holder in due course makes good sense only in a world where people buy and sell debts freely without talking to the debtors. It comes up and makes a difference, usually, in hard cases: John Doe or Dealer was quite innocent and has suffered a grievous wrong. You will never understand the concept by matching the equities of Harvard Trust Company against those of John Doe in the hard case. You must bear in mind the thousands of cases where nothing goes wrong. The bank does not recover from Doe because it bargained for the fruits of Dealer's fraud: judges and other people do not think highly of bargains for the benefits of fraud. The bank recovers so that it will be willing to buy notes without taking time to check up the way people do when they buy land."

In applying the above quotation to our case "Doe" should be read as "appellants"; "Dealer" should be read as "Fuline"; and "Harvard Trust Company" and "Bank" should be read as "appellee."

Even if a few cases (largely involving small consumer credit and extensive fraud) have developed a fiction of "direct participation" to justify ignoring the well established requirements under the N.I.L. of what is needed to show "bad faith" of a holder, we contend that such fiction should not be applied in this case so as to create a precedent which would overturn the existing sound and well developed commercial practices of the business world which are solidly based on existing law and public policy.

While a few courts in cases involving blatant fraud or small consumer transactions may have examined facts carelessly or applied the law loosely in order to help the "little guy" against the "big guy," we submit that a holding for the appellants in the





industrial transaction involved in our case would not only be in disregard of the facts involved, but would also be contrary to the great weight of well reasoned authority and would create a precedent which would be contrary to the sound public policy of the N.I.L. concept of a holder in due course which supports "free flowing credit" in the "thousands of cases where nothing goes wrong."

III. SINCE APPELLEE PURCHASED THE NOTES FROM FULINE FOR VALUE, AND TOOK POSSESSION AND DELIVERY OF THE NOTES FROM FULINE, AND SINCE IT WAS UNDERSTOOD, AND INTENDED THAT THE NOTES WERE TO BE ENDORSED BY FULINE TO APPELLEE, APPELLEE'S STATUS AS A HOLDER IN DUE COURSE IS NOT DEFEATED BY THE FACT THAT THE PRINTED TEXT OF THE ENDORSEMENT ON EACH OF THE NOTES SHOWS THE NAME OF THE ENDORSEE TO BE "COMMERCE ACCEPTANCE COMPANY, INC."

N.I.L. Sec. 43 (R.C.W. 62.01.043; V.A.M.S. 401.043; O.R.S. 71.043 and K.S.A. 52-414) provides as follows:

"Where the name of a payee or indorsee is wrongly designated or misspelled, he may indorse the instrument as therein described adding, if he think fit, his proper signature."

This statute clearly recognizes the principle that an endorsee who is a holder of an instrument which wrongly designates or misspells his name as endorsee does not thereby lose his status as a holder in due course. Among the cases applying this section of the N.I.L. /See, e.g., Atlanta & Lowry National Bank v. First National Bank of Carrollton, 38 Ga. App. 768, 145 S.E. 521 (1928); Time Loan Service, Inc. v. Bukowitz, 203 Md. 562, 102 A.2d 289 (1954); Jorgensen Chevrolet Co. v. First National Bank of Red Wing, Minnesota, 217 Minn. 413, 14 N.W. 2d 618 (1944); Joseph Milling Co. v. First Bank of Joseph, 109 Or. 1, 216 Pac. 560 (1923) no case has been found where a wrongful designation or misspelling of an endorsee's name has been so applied as to cause an endorsee to lose his status as a holder in due course. From





the testimony and the findings of the trial court (R. 64, 83, 97), it is clear (a) that appellee was the actual and intended endorsee of the notes, (b) that its name was "wrongly designated or misspelled" within the meaning of N.I.L. Section 43, and (c) that the inadvertent error in designating appellee's exact name in the indorsement provided no basis for defeating appellee's status as a holder in due course.

For a detailed discussion on this point, we refer this court to the trial court's decision (R. 97-101) where a number of authorities are discussed and cited in support of the trial court's decision, including: 11 Am. Jur. 2d, Bills and Notes, Sec. 352, pp. 372-3 (1963); First Wisconsin Nat. Bank of Milwaukee v. People's Nat. Bank of Rocky Mount, Virginia, 136 Va. 276, 118 S.E. 82, 36 A.L.R. 736 (1923); Jorgensen Chevrolet Co. v. First National Bank of Red Wing, Minnesota, 217 Minn. 413, 14 N.W. 2d 618 (1944); First State Bank of Humbird v. Cox, 192 Wis. 566, 213 N.W. 290 (1927); Joseph Milling Co. v. First Bank of Joseph, 109 Or. 1, 216 Pac. 560 (1923).

Even if appellants were to argue that N.I.L. Sec. 43 does not apply to this case, it is clear that appellee would be a holder in due course by virtue of relevant provisions of N.I.L. Sec. 9. Thus, in Washington and Kansas, N.I.L. Sec. 9 has been codified, in part (R.C.W. 62.01.009; K.A.S. 52-209) to read:

"The instrument is payable to bearer: ...

"(3) When it is payable to the order of a fictitious or nonexistent person, and such fact was known to the person making it so payable; ..."

and in Missouri and Oregon it has been codified, in part (V.A.M.S.





"The instrument is payable to bearer: ...

"(3) When it is payable to the order of a fictitious or nonexistent or living person not intended to have any interest in it, and such fact was known to the person making it so payable..."

Although Commerce Acceptance Company, Inc. was an existing corporation, the law relating to both of the above versions of this N.I.L. provision is well established that the payee named in an instrument will be deemed a fictitious person though designating an existing person, if there was no intent that he should have a beneficial interest in the paper. American Sash & Door Company v. Commerce Trust Co., 332 Mo. 98, 56 S.W. 2d 1034, 1040 (1933); Ritter v. Moore, 64 Ida. 144, 128 P.2d 639 (1942); Soekland v. Storch, 123 Ark. 253, 185 S.W. 262 (1916); Croswaite v. Pierce, 56 Wn. 2d 725, 355 P.2d 160 (1960); Goodyear Tire and Rubber Co. of California v. Wells Fargo Bank and Union Trust Company, 1 Cal. App. 2d 694, 37 P.2d 483 (1934); Portland Postal Employees Credit Union v. United States National Bank of Portland, 171 Or. 40, 135 P.2d 467 (1943). Applying this law to the facts of the present case, appellee would be the holder and the holder in due course of the notes as the bearer thereof.

That the "fictitious payee" doctrine of N.I.L. Sec. 9(3) applies to fictitious indorsees is made clear in a well reasoned, and well supported, decision, Hall v. Bank of Blasdell, 306 N.Y. 336, 118 N.E. 2d 464 (1954) which did not involve a fictitious indorsee. The applicable rule is stated at page 696 of Britton On Bills and Notes (1943) as follows:

"If an instrument is made payable to the order of



a designated payee whether such payee is a real person or a not-existing person and the person who made the instrument so payable, whether such person was the drawer himself, or an agent of the drawer or a forger of the drawer's name, and such person intends that the designated payee shall have no interest in the instrument and further intends that the person to whom he, in fact, issues the instrument shall have the interest therein, such instrument is treated just as if it were payable to bearer.

Fictitious indorsees also fall within the above rule." (Emphasis added)

While the facts in Croswaite v. Pierce, 56 Wn. 2d 725, 355 P.2d 160 (1960), deal with a payee, the court at 355 P.2d 162 indicates that the same rule applies to indorsees when it states:

"It is well settled that a 'fictitious' person within the meaning of the act, may be an actual person so long as the maker or endorser does not intend the named payee to receive the note or other negotiable instrument. Hall v. Bank of Blasdel, 306 N.Y. 336, 118 N.E. 2d 464; ... ." (Emphasis added).

Thus, appellants find themselves defeated on all sides. If they admit as the court below found (R. 97, 64, 83) that the name "Commerce Acceptance Company, Inc." was erroneously used to name appellee as endorsee of the notes, then appellee would be the endorsee and a holder in due course of the notes by virtue of the provision of N.I.L. Sec. 43 relating to misnomer. If appellants try to argue that, even though Commerce Acceptance Company, Inc. was not intended to be the endorsee of the notes, it nevertheless was an existing corporation, then appellants run afoul of the provisions of N.I.L. Sec. 9(3) which, under the facts of this case, would treat the notes as being payable to a fictitious person and thus payable to the bearer - i.e., appellee. Thus, it is clear that there was an endorsement to





appellee (either by misnomer or as bearer). For a similar case allowing alternative recovery under N.I.L. Sec. 43 or 9(3), see Atlanta & Lowry National Bank v. First National Bank of Carrollton, 38 Ga. App. 768, 145 S.E. 521 (1928).

In view of the preceding discussion, appellants' contention that the notes weren't regular on their face is obviously inapplicable. The notes were regular on their face and no evidence has been offered to the contrary. Appellants argue that the notes weren't regular on their face because of the erroneous (or fictitious) designation of the name of the endorsee on the endorsement on the rear of the notes. This argument is disposed of by the discussion above relating to the provisions of N.I.L. Sec. 43 and 9(3) and the case law applicable thereto. Appellants have cited no authority for applying the defense of "irregularity on face" to a case where either of N.I.L. Sections 43 or 9(3) are applicable.

Appellants contend that the law of Oregon is the ~~choice~~ choice of law rule to be applied here, and although the court below found no necessity for dealing with a conflict of laws issue since all four of the states involved had identical statutes at all times in question, since appellants raise the issue again we will discuss it here.

This being a diversity case there is no question but that the applicable choice of law is that which would be applied by the Oregon Courts. The Supreme Court of Oregon has clearly announced the basic choice of law rule for bills and notes in Oregon:

"In general, the place of performance of





a bill or note, that is, the lex loci solutionis, is the place of payment. Where a bill or note is executed in one state and made payable in another, the general rule is that it is governed as to its nature, validity, interpretation and effect by the law of the state or county in which it is payable, without regard to the place where it was written, signed, or dated, unless it clearly appears that the parties intended the contract should be governed by the law of the place where it was made." Sterrett v. Stoddard Lumber Company, 150 Or. 491, 46 P.2d 1023 (1935).

Since Kansas was the state in which the notes were payable, that would seem to settle the question unless appellants can show, which they do not attempt to do, that the parties clearly intended that the applicable law should be the place of execution of the notes, which incidentally, was Washington, not Oregon.

Appellants make much of the unreported case of Challenge-Cook Bros. Inc. v. Topline Equipment Company, Civil 63-278 (DC - Or. 1963), but the second paragraph of the court's opinion quoted by appellants, in which the court declined to apply the law of California where the note was payable, clearly illustrates that Judge Kilkenney did not reject the standard set forth by the Oregon Supreme Court in Sterrett. Although it is true that the secured property was located in Oregon, the note in that case was executed in Oregon, and the court undoubtedly found an intent on the part of the parties that Oregon law, the place of execution, should be applied. Nothing in the opinion suggests that the reason for applying Oregon law was the location of the secured property.

Perhaps more important in resolving that case, however, was the fact that it concerned the effect of the parol evidence rule which logically would follow the law of the state where the note was executed. That case did not involve the effect or





interpretation of a contract. In our case, the mere fact that some of the equipment subject to the mortgage was located in Oregon at the time of suit is by no means determinative of the conflicts question as applied to the notes secured by the mortgage. See, e.g., Oregon & W. Trust Investment Co. v. Rathburn, Fed. Cas. No. 10,555, 5 Sawy. 32 (C.C.A. Or. 1877). In any event, some of the equipment in our case was not located in Oregon, but in Washington.

The appellants' notes are the contracts involved in this case and appellants have shown no facts which would overcome the evidence that the contracts were made outside of Oregon. Applying any of the Oregon conflicts rules, it is clear that if the issue becomes pertinent at all, the law governing the holder in due course issue is not the law of Oregon.

Even if Oregon law were the governing law of this case, the one case relied upon by appellants [i.e., First National Bank of Pomeroy, Iowa v. McCullough, 50 Or. 508, 93 Pac. 366 (1908)] is completely inapplicable herein for the following reasons:

(a) The notes in the McCullough case were delivered to Nixon, the named payee, and Nixon sent the drafts in payment therefor to the endorser. In our case appellee received delivery of the notes and paid the consideration therefor and Commerce Acceptance Company, Inc. had no connection whatsoever with the transaction.

(b) There was no endorsement in McCullough from Nixon to the Bank while, in our case, as indicated by the discussion above relating to N.I.L. Sections 43 and 9(3), there was an endorsement to appellee in fact, in



the intention of the parties and by operation of law. Endorsement of the notes by Commerce Acceptance Company, Inc. to appellee was not necessary under N.I.L. Sections 43 and 9(3) for appellee to be a holder in due course.

(c) In McCullough, Nixon was cashier of the Bank but the endorsement to Nixon did not indicate his capacity as cashier. The court in McCullough was concerned with N.I.L. Sec. 42 (see O.R.S. 71.042) which provides in part:

"Where an instrument is drawn or indorsed to a person as 'cashier' or other fiscal officer of a bank or corporation it is deemed prima facie to be payable to the bank or corporation of which he is such officer..."

The defect in the McCullough note was that it did not show Nixon to be "cashier" and since the note was endorsed and delivered to Nixon but was not endorsed by Nixon to the Bank, the court held that this provision of the statute (i.e., N.I.L. Sec. 42) did not apply.

(d) The applicability of the provisions of N.I.L. Sections 43 (misnomer) and 9(3) (fictitious person) were not raised by the parties, and not considered by the court, in McCullough because Section 42 of the N.I.L. applied to the precise facts of a bank cashier receiving notes endorsed to himself.

Appellants misunderstand the McCullough case completely. In addition to the factual differences detailed above, the court there was not concerned with the same principles with which we are concerned here. Although the briefs filed in the case, to





which appellants prefer, make it clear that the bank was the intended transferee, the court refused to consider the issue and struck testimony thereof, because it would violate the parol evidence rule to read the endorsement "Pay A. B. Nixon or Order" as making Nixon the endorsee only in his capacity as cashier. All of this discussion in McCullough was for the purpose of rejecting the application of Sec. 42 of the N.I.L., which is not applicable here in any event.

The essence of the court's holding in McCullough, after rejecting the application of Sec. 42, was that Nixon, not the plaintiff bank, must be considered the endorsee; that the note was transferred from Nixon to the bank without an endorsement; and that unless an instrument is "evidenced by an endorsement," which it was not by the court's reasoning in this case based on Sec. 42, the transferee bank took subject to personal defenses. Neither Section 43 nor Section 9(3) of the N.I.L. was considered in McCullough.

The trial court below correctly stated the precise holding in the case that:

"The note sued on having been delivered by Nixon without endorsement, to the plaintiff, the bank was authorized to maintain an action thereon in its own name; but it took and held the paper subject to all equities existing in favor of the makers..." At p. 515. (Emphasis supplied.)

We submit that First National Bank of Pomeroy, Iowa v. McCullough, supra, is not only not applicable because of the conflict of laws rules discussed earlier, but also it has no application to the facts here. To apply appellants' interpretation of the applicable law and to ignore the obvious application of



N.I.L. Section 43 or Section 9(3) would completely defeat the policy of not only those sections but also the rest of the N.I.L. which seeks to promote commerce by protecting holders in due course.

Appellants have claimed that the notes were "indorsed" to Commerce Acceptance Company, Inc. We submit that the law and facts are clear that the notes were endorsed, and title as a holder in due course passed, to appellee. Appellants whole argument on this point of whether the notes were endorsed to appellee ignores the facts of this case and ignores the law applicable to these facts. Had Commerce Acceptance Company, Inc. given value for the notes (which it did not) and taken delivery of the notes (which it did not) and had Commerce Acceptance Company, Inc. been the intended endorsee (which it was not) and then delivered the notes to appellee (which it couldn't do because it never received the notes), then appellants' argument could be seriously considered. We must deal, however, with the actual facts and the law applicable thereto. In so doing, appellants' argument fails.

#### CONCLUSION

The judgment entered herein in favor of appellee should be affirmed.

Respectfully submitted,

BORDEN F. BECK, JR.  
BLACK & APICELLA





CERTIFICATE

I certify that, in connection with the preparation of this brief, I have examined Rules 18 and 19 of the United States Court of Appeals for the Ninth Circuit, and that, in my opinion, the foregoing brief is in full compliance with those rules.

BORDEN F. BECK, JR.  
Of Attorneys for Appellee



## APPENDIX A

The following are the relevant provisions of the N.I.L. with citations given to those provisions (or the modifications thereof) as codified in Missouri, Washington, Oregon and Kansas. Abbreviated citations used are as follows:

Revised Code of Washington - R.C.W.

Vernons Annotated Missouri Statutes - V.A.M.S.

Oregon Revised Statutes - O.R.S.

Kansas Statutes Annotated - K.S.A.

N.I.L. Sec. 9 (R.C.W. 62.01.009; K.S.A. 52-209)

"When Payable to Bearer. The instrument is payable to bearer:

- "(1) When it is expressed to be so payable;  
or
- (2) When it is payable to a person named therein  
or bearer; or
- (3) When it is payable to the order of a fictitious  
or nonexisting person, and such fact was known  
to the person making it so payable; or
- (4) When the name of the payee does not purport to  
be the name of any person; or
- (5) When the only or last indorsement is an in-  
dorsement in blank."

N.I.L. Sec. 9 as modified in Missouri (V.A.M.S. 401.009)  
and Oregon (O.R.S. 71.009)

"When Payable to Bearer. The instrument is payable to bearer:

- "(1) When it is expressed to be so payable; or
- (2) When it is payable to a person named therein or  
bearer; or





- (3) When it is payable to the order of a fictitious or nonexistent or living person not intended to have any interest in it, and such fact was known to the person making it so payable, or known to his employee or other agent who supplies the name of such payee; or
- (4) When the name of the payee does not purport to be the name of any person; or
- (5) When the only or last indorsement is an indorsement in blank."

N.I.L. Sec. 42 (O.R.S. 71.042)

"Instrument drawn or indorsed to fiscal officer of a bank or corporation. Where an instrument is drawn or indorsed to a person as "cashier" or other fiscal officer of a bank or corporation, it is deemed prima facie to be payable to the bank or corporation of which he is such officer, and may be negotiated by either the indorsement of the bank or corporation or the indorsement of the officer."

N.I.L. Sec. 43 (R.C.W. 62.01.043; V.A.M.S. 401.043; O.R.S. 71.043; K.S.A. 52-414)

"Indorsement in case of misspelled or wrongly designated name. Where the name of a payee or indorsee is wrongly designated or misspelled, he may indorse the instrument as therein described adding, if he think fit, his proper signature."

N.I.L. Sec. 52 (R.C.W. 62.01.052; V.A.M.S. 401.052; O.R.S. 71.052; K.S.A. 52-502)

"What constitutes a holder in due course. A holder in due course is a holder who has taken the instrument under the following conditions:

- "(1) That it is complete and regular upon its face;
- (2) That he became the holder of it before it was overdue, and without notice that it had been previously dishonored, if such was the fact;
- (3) That he took it in good faith and for value;





- (4) That at the time it was negotiated to him he had no notice of any infirmity in the instrument or defect in the title of the person negotiating it."

N.I.L. Sec. 55 (R.C.W. 62.01.055; V.A.M.S. 401.055; O.R.S. 71.055; K.S.A. 52-505)

"What constitutes defective title. The title of a person who negotiates an instrument is defective within the meaning of this chapter when he obtains the instrument, or any signature thereto, by fraud, duress, or force and fear, or other unlawful means, or for an illegal consideration, or when he negotiates it in breach of faith or under such circumstances as amount to fraud."

N.I.L. Sec. 57 (R.C.W. 62.01.057; V.A.M.S. 401.057; O.R.S. 71.057; K.S.A. 52-507)

"Rights of holder in due course. A holder in due course holds the instrument free from any defect of title of prior parties, and free from defenses available to prior parties among themselves, and may enforce payment of the instrument for the full amount thereof against all parties liable thereon."

N.I.L. Sec. 58 (R.C.W. 62.01.058; V.A.M.S. 401.058; O.R.S. 71.058; K.S.A. 52-508)

"Defenses against holders not in due course; rights of holder deriving title through holder in due course. In the hands of any holder other than a holder in due course, a negotiable instrument is subject to the same defenses as if it were nonnegotiable. But a holder who derives his title through a holder in due course, and who is not himself a party to any fraud or illegality affecting the instrument, has all the rights of such former holder in respect to all parties prior to the latter."

N.I.L. Sec. 59 (R.C.W. 62.01.059; V.A.M.S. 401.059; O.R.S. 71.059; K.S.A. 52-509)

"Proof that a holder is a holder in due course. Every holder is deemed prima facie to be a holder in due course; but when it is shown that the title of any person who has negotiated the instrument was defective, the burden is on the holder to prove that he, or some





person under whom he claims, acquired the title as a holder in due course. But the last mentioned rule does not apply in favor of a party who became bound on the instrument prior to the acquisition of such defective title."



No. 20908

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UNITED STATES COURT OF APPEALS  
FOR THE NINTH CIRCUIT

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ERLE G. SWANSON and )  
HELEN F. SWANSON, )  
husband and wife, )  
Appellants, )  
v. )  
 )  
 )  
COMMERCIAL ACCEPTANCE )  
CORPORATION, a Missouri )  
corporation, )  
Appellee. )

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APPELLANTS' REPLY BRIEF

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Appeal from the United States District Court for the  
District of Oregon

THE HONORABLE WILLIAM G. EAST, Judge

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FILED

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APPELLANTS' REPLY BRIEF

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Appeal from the United States District Court for the  
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THE HONORABLE WILLIAM G. EAST, Judge

---

GENERAL STATEMENT

Appellee cites 55 cases. Most of them merely support  
propositions which we conceded in our opening brief and as to  
which there is no dispute. We will, therefore, do as we did  
in our opening brief--confine ourselves to cases which are





## THE TRIAL COURT'S FINDINGS

We have no quarrel with the general proposition stated by appellee in this regard. Of course, the trial court's findings of fact will not be disturbed, and we agree with appellee's authorities. Appellee correctly states on page 7 of its brief, that "the scope of review is limited to the application of the law." With this we also agree. There is no contention on our part that the findings of fact are in error. All that is involved in this case is the application of the law to the facts as found by the court.

In its findings (R.87), the lower court found that prior to the time that the notes and mortgages were executed, the seller, Fuline, delivered to appellee the appellants' application for a franchise containing their financial statement and credit information, a verification of bank balance, and an executed copy of Fuline's form of request for financing [Ex. 10 (A) (B) (C)] which request was approved prior to the execution of the first note and mortgage.

The lower court also found that in the second transaction giving rise to the second note and mortgage, the matter was submitted orally to the appellee, and approved by it prior to the time that the second note and mortgage were drawn and executed by appellants (R.88). The other crucial findings of fact are contained in the other findings of the court including a history of past dealings, use of the finance company's forms, etc.



In the court's decision, it is made clear that the conclusion that the finance company did not "participate in the transaction" is one of law. This is made clear on page 12 of the decision (R.95) because this statement is included under the heading related to the applicable statutory text and case law as applied to the previously found facts. This case was decided on the basis of what, as a matter of law, constitutes "participation in the transaction."

We take exception to the appellee's statement that appellee had no contractual duty to purchase the paper in question and that we have ignored the findings and conclusions of fact of the trial court (see appellee's brief, page 8).

While it is true that Fuline was not legally bound to sell the paper to the appellee, the appellee was legally bound to purchase the paper when presented to it. As we set forth above, the court clearly found that the applications were made to the appellee to finance the two transactions. After their approval by appellee, the exact terms were later incorporated in the notes and mortgages. The first application was made in writing (Ex. 10-C) and the second application was made orally. Thus, the appellee did have the contractual duty to purchase the paper when, as and if submitted to it. That these are the lower court's findings is made clear in the portion of the opinion relating to legal conclusions where the court states that the "sole participation in the transaction" on the part of appellee was "to give a commitment that it would, if offered, purchase the notes and their respective securities\* \* \* \*" (R.95).





This commitment was also, as clearly found by the court, accompanied by the investigation and approval of appellants' credit, the use of the printed forms on which the note and mortgage were printed on a single sheet of paper with the note undetached, and a history of past dealings. In addition, on page 14 of his decision (R.97) the court makes it clear that his legal conclusion is that even though there was "furnishing of forms of notes and mortgages (being attached on the same sheet of paper), reviewal of the maker's financial statement, dealings of prior transactions, and prior commitment to purchase or discount" this does not, as a matter of law, constitute active participation or make the finance company a party to the transaction. It is this conclusion of law that we dispute.

#### APPELLEE'S AUTHORITIES

Turning to the cases cited by the appellee, do they support the court's legal conclusion and would they be followed by the Oregon Supreme Court if it were deciding this case?

On page 11 of its brief, appellee cites a number of cases holding that the fact that the note and chattel mortgage are executed concurrently or on the same piece of paper has been repeatedly held not to defeat the status of holder in due course. With this we agree. We so conceded in our opening brief. The same thing is true of the other statements for which authority is cited that the furnishing of forms does not prevent holder in due course status nor does the fact that the



In the case at bar, all of the foregoing factors are present, and in addition, there was the investigation of the credit of the appellants plus the commitment of the finance company prior to making of the sale that it would finance the transaction based on the amount and exact terms later incorporated in the notes and chattel mortgages which were purchased by it pursuant to its prior commitment.

On page 11 and 12 of its brief, appellee cites the following cases for the proposition that investigation of credit will not prevent holder in due course status:

- (a) Commercial Credit Corporation v. Smith, 143 Misc. 478, 256 N.Y.S. 759 (1932). This City Court of Buffalo, New York decision clearly shows that the investigation was made after the note was signed. This is a far cry from the case at bar. Obviously, the finance company did not participate nor was it a party to the transaction where the note had already been executed prior to the submission of the same to it for its investigation of credit.
- (b) Intges v. People's Finance & Trust Co., 44 S.W. 2d 1028 (1931). In this Texas Court of Appeals case, no finance company was involved. This was an ordinary note; there was no element of the use of printed forms, prior dealings, etc.
- (c) White System of New Orleans, Inc. v. Barganier, 172 So. 2d 741 (1965). Examination of this Louisiana, Fourth Circuit, Court of Appeals case





shows that there is no evidence or indication that the investigation of credit was made prior to the time that the note was written.

Turning to the appellee's statement that it is immaterial that prior to the making of the sale, there was a commitment to finance the transaction, the authorities cited are as follows, (appellee's brief, page 13):

- (a) White System of New Orleans, Inc. v. Hall, 219 La. 440, 53 So. 2d 227 (1951). This, and a subsequent Louisiana case, *infra*, are the only modern cases from a court of last resort that we could find where every factor present in the case at bar was involved and the court held that the finance company was a holder in due course. The court recognizes and refuses to follow the then decided cases cited by us in our opening brief.
- (b) Morgan v. Mulcahey, 298 S.W. 242 (1927). This case, decided by the Kansas City Court of Appeals (Mo.) involved a commitment on the part of an endorsee to a seller, prior to the sale of a car, that the ensuing note would be purchased. There is no indication that there was the use of attached printed forms, past dealings, etc.
- (c) National Bond & Investment Co. v. Miller, 76 S.W. 2d 703 (1934). This is also a Kansas City Court of Appeals case and it would appear to be directly in point in that the finance company's forms were



used and it had agreed to take the paper before it was written.

- (d) James Talcott, Inc. v. Shulman, 82 N.J. Super. 438, 198 A.2d 98 (1964). In this Appellate Division of the Superior Court of New Jersey case, it appeared that there was a discounting arrangement between the seller and the finance company, and that the finance company's printed forms were used. However, there is no indication in the case that the finance company had given its prior commitment to purchase the particular paper involved.
- (e) New Jersey Mortgage and Investment Corp. v. Calvetti, 68 N.J. Super. 18, 171 A.2d 321, (1961). All that can be said for this case is that the Superior Court of New Jersey, Appellate Division, stated that it was immaterial as to when the finance company was approached. As we have shown, except for the Louisiana Supreme Court, courts of last resort have regarded this factor as being highly material and decisive in that, as a participant or party to the transaction, the finance company is not entitled to holder in due course status.
- (f) Universal C.I.T. Credit Corporation v. Alker, 239 La. 1057, 121 So. 2d 78 (1960). This is the second Louisiana Supreme Court case which involves the factual situation in the case at bar. It also recognizes the line of authorities upon which we rely and refuses to follow them.





(g) Singer v. National Bond & Investment Co., 218 Ala. 375, 118 So. 561, (1928). In this case decided by the Alabama Supreme Court in 1928, the facts show that there was a previous arrangement between the finance company and the payee of the note that the finance company would purchase it when it was executed. In its opinion, the Alabama Supreme Court stated, "We are cited to no authorities to the effect that this alone has a tendency to deprive plaintiff of its rights as a bona fide purchaser for value of negotiable paper." At the time this opinion was written, we agree that there was no authority. Now there is the substantial and well-reasoned authority upon which we rely.

#### CONCLUSION

In its brief, the appellee keeps repeatedly arguing that what we are really saying is that there was a lack of "good faith" on the part of the appellee. We stated in our opening brief, and we repeat, we are making no such contention. We are not claiming that there was any "bad faith" on the part of the finance company nor are we contending that it participated in the transaction in the sense that it dealt with the Swansons directly, or that it warranted the machines in question, or that Fuline was its agent. Under the authorities that we cite and urge this court to follow, there is no such requirement.



In the cases we cite and rely upon, there was a three-party transaction. The seller performs the function of selling the goods to the buyer and the finance company finances the sale. All three parties are participants. The seller and the buyer make a tentative arrangement to conclude the transaction, including the submission to the finance company. It is only when the finance company agrees to play its part that the transaction is completed through the cooperation of all three parties (see Ex. 2, letter of May 1, 1962, Fuline to Appellants, "We are happy to advise you that your credit has been approved by the finance company\* \* \* \*").

The notes in question were not, at least as far as the immediate parties to the transaction are concerned, launched into the channels of commerce so that they would pass from hand to hand unencumbered by defenses. The notes in question were drawn to meet the requirements of the particular commitment issued by appellee which would make it possible for the sale to be concluded. Therefore, to say as appellee does, that the "original transaction" was the sale of the equipment, and that appellee did not have a direct participation in this transaction is obviously in error. There would have been no such transaction unless all three parties had participated. The status of a holder in due course should not and is not afforded to a party to the transaction. As the court said in Commercial Credit Co. v. Childs, 199 Ark. 1073, 137 S.W. 2d 260, 261, "Rather than being a purchaser of the instrument after its execution it [the finance company] was to all intents and





purposes a party to the agreement and instrument from the beginning\* \* \* \*".

Respectfully submitted,

DENTON G. BURDICK, JR.  
HUTCHINSON, SCHWAB & BURDICK



No. 20915 and No. 20916

IN THE

**United States Court of Appeals**  
FOR THE NINTH CIRCUIT

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TIM W. LILLIE and INGEBORG V. LILLIE, husband and  
wife (Docket No. 20915) and PEARL LILLIE, an indi-  
vidual (Docket No. 20916),

*Petitioners,*

*vs.*

COMMISSIONER OF INTERNAL REVENUE,

*Respondent.*

---

**BRIEF FOR PETITIONERS.**

---

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**FILED**

**AUG 19 1966**

**WM. B. LUCK, CLERK**

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No. 20915 and No. 20916

IN THE

# United States Court of Appeals

FOR THE NINTH CIRCUIT

---

TIM W. LILLIE and INGEBORG V. LILLIE, husband and wife (Docket No. 20915) and PEARL LILLIE, an individual (Docket No. 20916),

*Petitioners,*

*vs.*

COMMISSIONER OF INTERNAL REVENUE,

*Respondent.*

---

## BRIEF FOR PETITIONERS.

---

This is a proceeding pursuant to a consolidated Petition for Review of two (2) decisions of The Tax Court of the United States. The cases involve a deficiency in Federal income taxes of petitioners in the following amounts for the following calendar years:

Tim W. Lillie and Ingeborg V. Lillie (Docket No. 20915)

<u>Year</u>	<u>Deficiency</u>	<u>Penalties</u>	
		<u>§ 6651(a)</u>	<u>§ 6653(a)</u>
1956	1,228.88	.....	None
1959	3,696.25	.....	None
1960	214.78	20.98	None
1961	<u>976.76</u>	<u>.....</u>	<u>None</u>
Total	6,116.67	20.98	None

Pearl Lillie (Docket No. 20916)

<u>Year</u>	<u>Deficiency</u>	<u>Total</u>
1960	7,607.38	7,607.38

The cases were consolidated and heard before the Honorable Howard A. Dawson, Jr. on May 7, 1965, at Los Angeles, California.

Unless otherwise indicated, figures in brackets herein refer to the page numbers of the printed record as prepared and filed April 6, 1966, by the Clerk of the United States Court of Appeals for the Ninth Circuit. Figures in parentheses preceded by the letters "TR" refer to the pages of the official transcript of the hearing before The Tax Court of the United States.

### **Jurisdictional Statement.**

In accordance with §6213 of the Internal Revenue Code of 1954 (hereinafter for convenience referred to as the "1954 Code"), the taxpayers (petitioners herein), within 90 days after notices of deficiency in Federal income taxes for the years set forth above were mailed to them, filed in The Tax Court of the United States separate petitions for redetermination of such deficiencies (Document Nos. 3, 7), which petitions were duly docketed and the cases consolidated for trial, briefing and decision.

The Tax Court affirmed a portion of such deficiencies and denied a portion of such deficiencies in decisions entered under Rule 50 of the Rules of The Tax Court on January 20, 1966. [R. 30, 32.]

A Petition for Review was filed jointly by the taxpayers (petitioners herein) on March 2, 1966, in accordance with §7483 of the 1954 Code [R. 33], seeking review by this Court of the decisions of The Tax Court.

The jurisdiction of this Court to review the decisions of The Tax Court arises under §7482(a) of the 1954

Code, and venue herein is properly established in accordance with §7482(b) of the 1954 Code by virtue of the fact that the taxpayers (petitioners herein) filed their Federal income tax returns for the years 1956 through 1961 (the taxable years in which the subject deficiencies arise) in the office of the District Director of Internal Revenue at Los Angeles, California. [R. 1, 6.]

Even if a “clearly erroneous” showing were required (which is not the case), it is submitted that this Court has full jurisdiction to review this case under the circumstances. *Gillette Estate v. Commissioner*, 182 F. 2d 1010 (9th Cir., 1950), 39 A.F.T.R. 612.

### **Opinion Below.**

The Findings of Fact and Opinion of The Tax Court in the cases were filed therein on October 14, 1965 [R. 11] and are officially reported in 45 TC No. 3.

### **Question Presented.**

During the taxable years 1959, 1960 and 1961, the taxpayers were engaged in the business of feeding cattle for profit and reported their income on the cash receipts and disbursements method; they deducted the cost of payments made for feed as business expenses in the year of payment, and the sellers of feed reported these transactions as sales and reported the payments as income in the year of payment. The Commissioner of Internal Revenue allowed as a business expense only that portion of the deductions which represents feed actually consumed by the taxpayers' cattle in the year of payment and allocated the balance of the feed expense to the following year.



The question for decision is: Are payments for feed, all of which is ultimately consumed by cash-basis taxpayers' cattle, deductible expenses in the year of payment; or must such expenses be allocated to the year in which the feed is actually consumed?

### Statutes and Regulations Involved.

#### *Internal Revenue Code of 1954:*

"Sec. 162. TRADE OR BUSINESS EXPENSES.

(a) IN GENERAL.—There shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business . . ."

'Sec. 461. GENERAL RULE FOR TAXABLE YEAR OF DEDUCTION.

(a) GENERAL RULE.—The amount of any deduction or credit allowed by this subtitle shall be taken for the taxable year which is the proper taxable year under the method of accounting used in computing taxable income."

#### *Treasury Regulations:*

"Sec. 1.162-12. EXPENSES OF FARMERS.

". . . The purchase of feed and other costs connected with raising livestock may be treated as expense deductions insofar as such costs represent actual outlay . . ."

"Sec. 1.461-1. GENERAL RULE FOR TAXABLE YEAR OF DEDUCTION.

(a) GENERAL RULE.—

(1) Taxpayer using cash receipts and disbursements method. Under the cash receipts and dis-

bursements method of accounting, amounts representing allowable deductions shall, as a general rule, be taken into account for the taxable year in which paid.”

“Sec. 1.471-6. INVENTORIES OF LIVESTOCK RAISERS AND OTHER FARMERS.

(a) A farmer may make his return upon an inventory method instead of the cash receipts and disbursements method. *It is optional with the taxpayer which of these methods of accounting is used . . .*” (Emphasis added.)

Revenue Rulings:

Special Ruling, T. Mooney, Deputy Commissioner, Dec. 16, 1943:

“Reference is made to your letter dated December 4, 1943, in which you state that several individual cattle feeders are located in your district who file their income tax returns on a cash receipts and disbursements basis. The individuals purchase large amounts of grain in addition to crops raised, all of which are for feeding purposes. The cattle in question are purchased and usually sold in the year subsequent to the year of purchase.

“You request to be advised whether the cost of the feed purchased should be deducted in the year payment therefor is made or whether it should be apportioned to the year in which it is consumed; or, in other words, whether it is considered to be an item of general expense or an item to be considered in computing gross income.

“In the case of a taxpayer on the cash receipts and disbursements basis, the amounts expended

for feed should be deducted as an expense in the year in which the feed is paid for, irrespective of the fact that it may not be consumed until the following year. (Letter to Collector of Internal Revenue, Des Moines, Iowa, dated Dec. 16, 1943, signed by T. Mooney, Deputy Commissioner.)”

### Errors Relied Upon.

1. The characterization by The Tax Court of payments for feed as “deposits” was erroneous and determinative of the results in this case, and the inferences and conclusions drawn by The Tax Court to arrive at such characterization were based on errors and a misreading of the evidence. From this characterization, The Tax Court “bootstrapped” itself to what it denominated a “finding of fact” but which, in truth, was a finding of ultimate fact—a mixed question of law and fact subject to full review by this Court on appeal.

2. The conclusion of The Tax Court that, because a “portion” of the purchase price paid for feed included some prepayment for “services” to be performed at a future date, therefore the *entire* price paid for feed must be characterized as prepayment for services was erroneous.

3. The characterization by The Tax Court that the repurchase of taxpayers’ feed inventory by McCabe Cattle Co. in 1961 in settlement of a dispute and upon termination of a feeding agreement amounted to a “refund” was erroneous.

4. The conclusion of The Tax Court (after characterizing the repurchase of feed by McCabe in 1961 as a “refund”) that because taxpayers received *one* “refund” in *one* year, in a single, isolated transaction, that there-

fore *all* feed purchases in *all* years from *all* feed suppliers should be characterized as “deposits” was erroneous.

5. The statement by The Tax Court at page 8 of the reported opinion [R. 18] that taxpayers were not required to pay for feed in advance of consumption is erroneous and directly contrary to the evidence presented in the case.

6. It was error for The Tax Court to fail to distinguish its holding in the case of *John Ernst v. Commissioner*, 32 T.C. 181 (1959) from the instant case. At pages 14, 15 of the reported opinion in this case [R. 24, 25] The Tax Court distinguished *Ernst* from the case of *Cravens v. Commissioner*, 272 F. 2d 895 (C.A. 10, 1960), 60-1 U.S.T.C. ¶9139, reversing 30 T.C. 903, but failed to indicate any valid reason for not following *Ernst* in the present case.

7. The statement by The Tax Court at page 17 of the reported opinion [R. 27] that petitioners were “charged the current market price, not a predetermined price, when the feed was consumed . . .” is erroneous and directly contrary to the evidence (Tr. 44, 71, 84, 99, 101 and 116) and agreed facts contained in the Supplemental Stipulation of Facts [R. 8].

### Statement of Facts.

*Tim W. and Ingeborg V. Lillie* are husband and wife, and Pearl Lillie is the mother of Tim. Ingeborg is a party to this action only because she filed joint income tax returns with her husband; therefore, where the words “petitioners” and “taxpayers” are used, they refer to Tim and Pearl. Both petitioners keep their books and report their income on a calendar year basis and



on the cash receipts and disbursements method of accounting.

During the years 1959, 1960 and 1961, Tim fed cattle for profit in Imperial County, California. Pearl joined him in this venture in 1960, and both have been actively engaged in the cattle business ever since.

The cattle owned by petitioners during these years were located in the commercial feed yards of Heber Cattle Feeders and McCabe Cattle Co. Petitioners entered into oral agreements with Heber and McCabe whereby petitioners were obligated to pay in advance for feed purchased for consumption by their cattle. (Tr. 13, 76, 83.) Toward the end of each year petitioners made payments to Heber and McCabe for feed and deducted such payments as expenses in the year of payment. The sellers reported those transactions as "sale" of feed and reported their receipts for tax purposes as "income" from sales.

At all times when payments for feed were made, petitioners had cattle on hand and all of the feed purchased was ultimately consumed by petitioners' cattle with the exception of one portion of feed inventory at McCabe in the year 1961, which portion was resold to McCabe upon discontinuance of feeding cattle at McCabe as the result of a dispute between McCabe and petitioners.

In every feed purchase transaction pertinent to this proceeding, both the seller and the buyer envisioned no refund of any amounts paid and no provision was made for any "refund" (Tr. 14, 19, 22, 23, 65, 67, 80, 107, 110, 136); Opinion—Findings of Fact at pages 6 and 7. [R. 16, 17.]

Historically, the custom and practice in the cattle-feeding industry in Imperial Valley, from the earliest

time cattle were custom-fed commercially by feed-sellers up to and including the present time, is to sell feed at a certain price per ton which includes ingredients, mixing, delivery to the pens and use of the sellers' corrals. Sellers do not segregate the costs of "services" for mixing and delivery, etc. The actual cost of ingredients furnished to the customer comprises more than ninety (90%) percent of the sale price of the feed, and that amount can readily be determined on any given date.

The custom cattle-feeding business is a highly competitive industry, and the sales potential of the seller depends on the numbers of head of cattle of customers each seller can adequately house and feed in his "yard" (corrals). Each customer makes his own agreement with the feed-seller as to method of payment for feed based on the customer's history and credit rating. Some customers who are new to the business and whose only collateral for feed is the number of cattle located in the yard are required to pay for feed in advance; others with a history and other collateral are permitted to "accrue" feed bills until their cattle are sold; others may pay for feed consumed by computing the amount of "gain in weight" put on the cattle over a period of time multiplied by a price-per-pound formula. Petitioners, at the times pertinent to this determination, were required to pay for feed in advance. (Tr. 13, 76, 83.)

At all times pertinent to this determination, neither the sellers of feed nor petitioners intended payments to be "deposits" (Opinion [R. 28]; Tr. 63, 76, 79, 94, 107, 109, 135; Ex. 9-I, P, Q, R, S and T), and the price of feed consumed by petitioners' cattle was accounted for at the price as of the time of payment and not as of a subsequent date when consumed. (Tr. 44, 71, 84, 99, 101 and 116.)

## ARGUMENT.

### Preliminary Statement.

Although the issue in this proceeding involves the disallowance of deductions of certain payments made for cattle feed by cash-basis taxpayers in the year of payment, The Tax Court precluded a fair determination of the issue by characterizing the payments as “deposits” prior to an analysis of the evidence and the law. After thus assuming the ultimate issue of the case and denominating it a “finding of fact”, the Court then attempted to justify such a “finding”, and in so doing drew erroneous inferences and conclusions which should leave this Court with the definite and firm conviction that a mistake has been made by The Tax Court.

Whether the payments made were in consideration of the purchase and sale of feed or “merely deposits” was not a question properly before The Tax Court and is a question which should be decided by the law of sales. The decision of The Tax Court on this point (*having not been tried below*) is contrary to the law of sales as established by the cases of *Percy W. Phillips*, 30 T.C. No. 87 (1958), and *Jack Benny*, 25 T.C. 197 (1955), and therefore is subject to complete review by this Court.

The provisions of §§162(a) and 461(a) of the 1954 Code, *supra*, have been a part of the Federal tax law, without material change, for over twenty years. They provide that a cash-basis taxpayer shall be entitled, as a matter of law, to deduct all ordinary and necessary expenses incident to the conduct of a trade or business in the year of payment.



Petitioners submit that the opinion of The Tax Court in this case has distorted the true issue of determining the year of deductibility of payments made for live-stock feed into two issues which were not tried below:<sup>1</sup>

- (a) What constitutes a “deposit”?
- (b) Does the inclusion of “services” in the cost of feed disqualify a cash-basis purchaser from deducting the cost of ingredients in the year of payment?

---

<sup>1</sup>The determination by this Court on these questions will have far reaching consequences. The case at hand is a test case in which much more is at stake than the deficiencies involved. This case represents an attack by the Commissioner on the continued availability of the cash-basis method of accounting for persons engaged in the cattle-feeding industry. As this case comes before this Court on appeal, the District Director of Internal Revenue for the Los Angeles, California, District has a large backlog of audits pending in Imperial County in which the Reviewing Agent has been instructed to deny deductions to any cattle feeders who prepay feed expenses and to force such taxpayers to keep inventories. At the same time, the Reviewing Agent has been instructed to deny claims for adjustments to inventories of feed sellers on amended returns where the seller reports prepayments of feed as “deposits”. These taxpayers are being requested to execute extensions of the statute of limitations pending the outcome of this case on appeal.

It is submitted that if this attack by the Commissioner is successful there will be no feasible way for a cash-basis cattle-feeder to obtain an expense deduction for the purchase of fungible goods in advance of their consumption because of the inclusion in the price of feed of certain “services” which are yet to be performed by the seller (feed lot operator). This could result in serious economic chaos in the custom cattle-feeding industry which is now one of California’s largest industries. Credit policies of all custom feed lot operators could be placed in serious jeopardy, and the number of cattle being fed in custom feed yards would be greatly reduced.

It is further submitted that the revenue to the Treasury Department will not be increased or diminished significantly by upholding the position taken by the Commissioner in this case, since the deduction denied in one year must be allowed in the following year when the feed is consumed. In the instant case, the ultimate position of petitioners resulted in a net refund after the subsequent years were adjusted to reflect the decision of The Tax Court concerning the taxable years under litigation.



The status of the law, as pronounced by decisions of the courts in *John Ernst v. Commissioner*, 32 T.C. 181 (1959), *Cravens v. Commissioner*, 272 F. 2d 895 (CA-10, 1960), reversing 30 T.C. 903, 60-1 U.S.T.C. ¶9139; *Shippy v. United States*, 199 F. Supp. 482 (D.C. W. Dist. SD., 1961), 62-1 U.S.T.C. ¶9203, and the published policy of the Commissioner of Internal Revenue, as set forth in Letter Ruling, T. Mooney, Deputy Commissioner, December 16, 1943. (as published in full at ¶66,149 of Prentice-Hall Federal Tax Service, 1944), prior to the opinion of The Tax Court in this case, was as follows:

Advance payments for feed made by cash-basis taxpayers are deductible in the year of payment where the following criteria is met:

- (1) Where the cash-basis purchaser of feed made payments which were absolute and the purchaser was irretrievably out of pocket the amounts paid; (*Ernst, supra*)
- (2) Where purchaser used the feed in carrying on a trade or business; (*Ernst, supra*)
- (3) Where the seller was unconditionally obligated to deliver to purchaser the quantity of feed which the amounts received would pay for *at the prices in effect on the dates of delivery*; (Emphasis added) (*Ernst, supra, Cravens, supra*)
- (4) Where both the purchaser and seller regarded the transactions as a "sale" and not a deposit and so reported it on their books of account; *Shippy, supra*)
- (5) Where there was no contractual provision for or contemplation of a refund by the parties at the time of payment; (*Ernst, supra*)

- (6) Where the agreement between purchaser and seller was binding and was carried out by the parties; (*Cravens, supra*)
- (7) Where the amount of the price was "paid" or "incurred" within the taxable year. (*Cravens, supra*)
- (8) The published policy of the Commissioner of Internal Revenue is stated as follows:

"Reference is made to your letter dated December 4, 1943, in which you state that several individual cattle feeders are located in your district who file their income tax returns on a cash receipts and disbursements basis. The individuals purchase large amounts of grain in addition to crops raised, all of which are for feeding purposes. The cattle in question are purchased and usually sold in the year subsequent to the year of purchase.

"You requested to be advised whether the cost of feed purchased should be deducted in the year payment therefor is made or whether it should be apportioned to the year in which it is consumed; or, in other words, whether it is considered to be an item of general expense or an item to be considered in computing gross income.

"In the case of a taxpayer on the cash receipts and disbursements basis, the amounts expended for feed should be deducted as an expense in the year in which the feed is paid for, irrespective of the fact that it may not be consumed until the following year. (Letter to Collector of Internal Revenue, Des Moines, Iowa, dated Dec. 16, 1943, signed by T. Mooney, Deputy Commissioner.)"

Until the language of the opinion in this case was issued, neither the courts nor the Commissioner had ever considered that the indirect costs and overhead of the feed-seller, which were included in the sale price of feed, were such "significant" services that the entire sales transaction should be characterized as "prepaid services" or "deposits." This novel theory, if permitted to stand, would nullify the law of sales.

I.

**The Payments by Petitioners Meet All of the Requirements Established by Tax Law and the Law of Sales to Qualify as Purchases of Feed and Were Not "Merely Deposits".**

The Tax Court in this case admits that it [The Tax Court] held in *Ernst v. Commissioner, supra*, that the petitioner was entitled to a deduction of "substantial" payments for feed made by a poultry feeder to his feed supplier in December of each year as ordinary and necessary expenses in the year of payment although the feed was not to be delivered until the succeeding years, the price was to be determined as of the subsequent date of delivery, the buyer "had no [none] need for the quantities of feed he paid for at the time of payment", and neither a sale nor sales income was taken into account on the books of the grain dealer until the feed was delivered in the succeeding years. [R. 24.] The Tax Court then relied upon its prior language in the *Ernst* case in distinguishing that case from *Cravens v. Commissioner, supra*, and sets forth the criteria used to determine that the poultry feeder's payments were "*not in the nature of deposits*" (Emphasis added):

- (1) There was no contractual provision for a refund.

- (2) The payments were absolute, and petitioner was irretrievably out of pocket the amounts paid.
- (3) The payments were incident to carrying on a trade or business.
- (4) Seller was obligated to deliver such quantity (unknown at the time of payment) of feed as the price to be in effect at the future date of delivery would use up.

In the instant case, petitioners rely on the standards established by The Tax Court in *Ernst, supra*:

- (1) The Tax Court found [R. 16, 17] that payments by petitioners to McCabe in 1960 were made with “*no provision for the refund of the sums paid*” and that the termination of feeding relationship between petitioners and McCabe which gave rise to the resale of feed inventory to McCabe “*had not been envisioned the previous December when he [they] made his [their] advance payments.*” (Emphasis added) All parties were of the belief at the time of payments that there was no possibility of refunds. (Tr. 14, 19, 22, 23, 65, 67, 80, 107, 110, 136.)
- (2) The Tax Court found [R. 20] that petitioners are “engaged in the business of raising cattle for profit” and “are entitled to deduct the cost of feed as an ordinary and necessary business expense under the provisions of §162(a) of the Internal Revenue Code of 1954.” (Incident to carrying on a trade or business)
- (3) The payments were absolute, and petitioner was irretrievably out of pocket the amounts paid. In fact the payments were intended, recorded on the



books of account of seller, and returned for Federal income tax purposes by *both* buyer and seller as completed sales transactions. (Tr. 63, 76, 79, 94, 107, 109, 135; Ex. P, Q, R, S and T.) Under the law of sales of the State of California, purchaser would have no legal basis for claim for refund.

- (4) In the instant case, there can be no question that a binding oral contract existed between petitioner and feed suppliers. Under basic, hornbook law of contracts where there has been an offer and acceptance, complete performance by one party (buyer) and partial performance by the other party (seller), mutual consideration, an unmistakeable meeting of the minds as to the intent of the parties, a legal purpose, and both parties competent, a binding contract exists. *Dartmouth College v. Woodward*, 4 Wheat. (U.S.) 518, 4 L. Ed. 629.
- (5) In the instant case, the prices were established as of the date of payment—not to be determined at the future delivery date. (Supp. Stip. [R. 8]; Tr. 13, 76, 83.)
- (6) In the instant case, the feed was *on hand* and “earmarked” and *delivered* (as fungible goods) as of the date of payment. (Tr. 15, 63.) The “quantum” was capable of immediate computation by use of the “mix” formula. Petitioners’ cattle actually consumed part of the feed in the year of payment.
- (7) In the instant case, petitioners had *immediate* need for a portion of the feed purchased and

subsequently used all the feed for the same cattle on hand at the date of purchase (with the exception of the isolated “incident” at McCabe in 1961).

The Tax Court stated in its opinion in this case [R. 23] “*that the possibility of a refund did not make the amount a deposit [in Cravens, supra] since the contract was binding and was carried out by the parties.*” (Emphasis added.) Petitioners submit that in the instant case the agreements were binding, carried out by the parties, and additional feed subsequently purchased and consumed for the same cattle.

Petitioners submit that the facts in the instant case fall squarely within the criteria and the holding of the U. S. Court of Appeals for the Tenth Circuit in *Cravens v. Commissioner, supra*, and the Tax Court in *Ernst v. Commissioner, supra*.

In the case of *George R. Shippy v. United States, supra*, a deduction for advance payment for feed was denied because:

- (1) The arrangement between the purchaser and the elevator (seller) was *not a contract*.
- (2) The seller regarded the arrangement as a “deposit” and so recorded it on his books of account.
- (3) Payment in advance was not requested or demanded by the seller.
- (4) The parties both contemplated a “refund” in the event future deliveries were not requested or made.

- (5) Feed was supplied from time to time in quantities ordered at each future date at the price in effect on the date of each delivery.
- (6) Buyer had a history with seller of paying *AFTER* feed was delivered—never in advance; then in the pertinent year involved, the payment was triple the normal purchases, *in advance*.

Petitioners submit that *Shippy* was decided correctly on its peculiar facts and that the instant case is patently distinguishable in that *none* of the above criteria of that case is found in the instant case. In the case at bar there were *binding contracts*, the parties recorded and paid taxes on the transactions as *completed sales*, there were *no provisions for or contemplation of refunds*, feed was on hand and *delivered* in a determined amount, the *price was fixed as of the date of payment* and not at a future undetermined price, there were no prior histories of payments *after* feed was consumed, and the amount of year-end purchases were uniform and *not abnormal* compared to amount of feed which was needed to feed cattle on hand.

## II.

### The Fact That Deductions for Feed Payments Had the Effect of Reducing Petitioners' Taxable Income for a Particular Year Is Immaterial.

Petitioners have admitted that one of the reasons payments were made in advance was because of the tax advantage. By purchasing feed in advance, petitioners had the advantage of "using" money which would not have been available without the tax deduction in the year of payment. *But this is not the issue in this case.*

So long as the purchase of feed was an ordinary and necessary business expense of petitioners' cattle-feeding business (and *The Tax Court* so found [R. 20]) it is wholly immaterial that petitioners selected a time for the purchase which would gain them tax advantages. The courts have long recognized that it is not improper to avoid or minimize taxes if lawful means are used and the transactions are not "shams". In the famous case of *Gregory v. Helvering*, 293 U.S. 465 (1935), the United States Supreme Court said, at page 469:

"The legal right of a taxpayer to decrease the amount of what otherwise would be his taxes, or altogether to avoid them, by means which the law permits, cannot be doubted . . ."

Petitioners submit that the rule of *The Tax Court* itself, with reference to the law of sales, is clearly stated in *Percy W. Phillips*, 30 T.C. No. 87 (1958). In that case the court held that a bona fide sale *must* be recognized even though it is made for the "*sole purpose of minimizing taxes.*" The same rule was clearly stated in *Jack Benny*, 25 T.C. 197 at pages 210, 211 (1955).

The Internal Revenue Service, in Rev. Rul. 58-162, C.B. 1958-1, 234, recognizes that cash-basis taxpayers may control the timing of income. In that ruling a cash-basis wheat farmer sold and delivered wheat to a purchaser under contracts calling for payment during the following year. The Service ruled that cash-basis farmers need only to report income in the year of receipt and that so long as such contracts are bona fide, they are effective to postpone [or accelerate] the realization of income.



III.

Certain Statements and Findings of Fact of the  
Tax Court Are Contrary to the Evidence.

A. The Tax Court Ignored or Misinterpreted the Supplemental Stipulation of Facts.

The Tax Court ordered a Supplemental Stipulation of Facts for the express purpose of resolving certain conflicting testimony as to whether the cattle feed-sellers (Heber and McCabe) charged petitioners for feed consumed at (1) the price determined at the time payment was made for the feed, or (2) the current market price at the time the feed was consumed (a matter which is immaterial if the *Ernst and Cravens, supra*, cases are followed).

Paragraph 1 of this Supplemental Stipulation states [R. 18]:

“1. Heber Cattle Feeders: The price of #1 mix feed was \$50.00 per ton from December of 1959 through September 1960. . . . The statement of Heber, joint Exhibit 9-I, states that Tim Lillie *purchased* #1 mix feed at \$50.00 per ton. Tim Lillie was charged for #1 mix feed *consumed* at \$50.00 per ton from December 1959 to August 1960.” (Emphasis added.)

NOTE: The only cattle fed by petitioners at Heber during this period were fed from December 21, 1959 through August 21, 1960, and all #1 mix feed was accounted for at \$50.00 per ton. (Ex. 10-J.) Petitioners did not feed cattle again at Heber until after the dispute with McCabe in July of 1961. In July of 1961, petitioners again fed cattle at Heber, and this lot was completed in Jan-

uary of 1962, with all feed purchased and consumed during a period which the Supplemental Stipulation shows the price remained unchanged. (Supp. Stip. Para. 1 [R. 8]; Ex. 11-K.)

Paragraph 2 of the Supplemental Stipulation stated [R. 9]:

“2. McCabe Cattle Co.: The price of #1 mix . . . was \$52.30 per ton from November 1960 through August 1961, for all customers.”

*NOTE:* Petitioners' cattle were started on feed purchased in November 1960 and were all completed and shipped as of July 1961—a period when the price did not change; therefore, the price *was in truth* the same at the date of consumption as at the date of payment. (Tim W. Lillie Stip. para. 8 [R. 3]; Pearl Lillie Stip. para. 5 [R. 7], Ex. 12-L, 13-M.)

Petitioners submit that the Tax Court was less than accurate when it stated [R. 27] that the evidence “shows that petitioners did not fix the price of feed at the market price on the date of payment” and that “they [petitioners] were charged the current market price, not a predetermined price, when feed was consumed.”

Petitioners further submit that if *Ernst v. Commissioner, supra*, is still as virile as The Tax Court in this case says it is, the question of “fixing” the price is immaterial since in that case the price was to be *as of the date of future delivery*.

**B. The Tax Court Ignored the Uncontradicted Testimony of Certain Witnesses.**

The Tax Court stated [R. 18] that petitioners were *not* “required to pay for feed in advance of consumption”. Yet the uncontradicted testimony of witnesses Virgil Torrence (Tr. 76), Paul Milstead (Tr. 83), and Tim Lillie (Tr. 13) shows that the agreement between petitioners and the feed sellers *required payment in advance*. (Emphasis added.)

The Tax Court stated that “customers of Heber and McCabe *could* pay monthly for the cost of feed consumed by their cattle and many of them did so.” [R. 18.] Yet the uncontradicted testimony showed that although many different methods of payment were available to *other* customers—(and in fact in later years, after petitioners had a history in the business, such “deals” were available to them) at the time pertinent to this case *prepayment was a condition of petitioners’ agreement* with feed suppliers. (Tr. 13, 76, 83.) (Emphasis added.)

**C. The Tax Court Ignored the Clear Statement of the Applicable Tax Laws Announced by the U.S. Court of Appeals for the Tenth Circuit.**

The Tax Court quoted the United States Court of Appeals for the Tenth Circuit [R. 24] as setting forth the Federal tax law and Congressional intent governing the deductibility of advance payments for feed as follows:

“In the case of farmers and cattle raisers the use of a transactional basis for the computation

of income would bring confusion into the federal tax system. The treatment of the cost of seed, fertilizer, and feed purchased in one year for use in the next year is simple if the deduction is allowed when paid if the cash basis applies or when incurred if the accrual basis is used.<sup>20</sup> If each transaction must be analyzed to determine whether a distortion of income will result from the allowance of a business expense deduction, §43 is, in our opinion, given a meaning which Congress did not intend. [Footnotes omitted.]”<sup>22</sup>

However, The Tax Court then ignored this statement of the law and distinguished the instant case *solely* on the strained and unnatural theory that the payments were not actually for feed but for “services” to be performed and that this fact, together with a “refund” [repurchase] in one year by one supplier, removed petitioners from the availability of the law. Petitioners submit that this was reversible error.

**D. The “Deposit” Theory of the Tax Court Is Inconsistent With the Record and Would Be Conclusive on the Issue of the Existence of a Binding Obligation.**

The Tax Court found it “unnecessary” to decide the Government’s primary contention at the time of trial; namely, that the allowance of the deductions of payments in question would distort petitioner’s income. This unnecessary was occasioned by the Court’s being lured into the finding of a “deposit” due to the so-

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<sup>22</sup>Section 43 of the Internal Revenue Code of 1939 is now §461(a) of the 1954 Code.



called “refund” in 1961 and the inclusion of the cost of services in the price of feed. [R. 27.] Once The Tax Court characterized the payments as deposits, the case was solved. However, sound reasoning would dictate that if the deposit theory were adopted, The Tax Court would then be obligated to follow *Ernst, supra*, and the record would preclude any other choice:

- (a) If there were a true sales “deposit” (a down-payment in the normal, ordinary business sense of the word), there would automatically be a “binding obligation”, *i.e.*, a firm sale contract which would then permit the parties to control the year of payment. Rev. Rul. 58-162, CB 1958-1, 234; *Percy W. Phillips, supra*, *Jack Benny, supra*. Therefore, by finding a “deposit”, the Court finds a binding sales contract.
- (b) If there were a bailment or surety type “deposit”, then the sellers would hold the property in a fiduciary capacity and not be entitled to the beneficial use thereof. But the record here is inconsistent with this theory because the uncontroverted evidence established that the suppliers had unrestricted use and enjoyment of the funds paid and no contractual provisions for refunds were made or even contemplated by the parties at the time of payment. [R. 16]; (Tr. 14, 19, 22, 23, 65, 67, 80, 107, 110, 136.) In fact, the sellers in the instant case paid tax on the proceeds which they treated as “income”.

Petitioners submit that neither the facts nor the law support a finding that the payments in question were deposits in the “bailment” or “surety” sense of the word. And if they are deposits in the “sales” sense of the word, the ultimate decision of The Tax Court must be reversed.

In The Tax Court, the Government cited several cases purporting to support their theories of deposit and distortion of income. Their inapplicability to the instant case has been covered in Petitioners’ Brief and Reply Brief filed in that Court, and mention is made of this matter to alert this Court that, in the event the Government should choose to rely upon them again in this appeal, the information contained in petitioners’ briefs should be included in these proceedings. The respondent has cited *Galatoire Bros. v. Lines*, 23 F. 2d 676 (C.A. 5, 1928), 6 A.F.T.R. 7213 (“advance rental payments by lessee”); *Robert S. Bassett*, 26 T.C. 619 (1956) (“prepaid medical expenses”); and *Boylston Market Ass’n v. Commissioner*, 131 F. 2d 966 (C.A. 1, 1942), 30 A.F.T.R. 512 (“prepaid insurance premiums”). These cases involve well recognized exceptions to the general rule that expenses may be deducted by a cash-basis taxpayer in the year of payment. As a matter of fact, the rule of *Boylston Market Ass’n.*, *supra* has been rejected in *Waldheim Realty & Investment Co. v. Commissioner*, 245 F. 2d 823 (8th Cir., 1957).

IV.

The Fact That the Price of Feed Included Incidental  
“Services” Already Performed and to Be Per-  
formed by Sellers Does Not Constitute a Rea-  
sonable Basis for Denying a Deduction for Pay-  
ments Made for Feed Ingredients and Services  
Performed in the Year of Payment.

It must be pointed out that the issue of the *value* of services “to be rendered by suppliers” in years subsequent to the year of payment was never tried below. At no time during the trial did the Government intimate or indicate that it was contending that a “substantial” portion of the price charged for feed included services *yet remaining to be performed* AFTER the year of payments. Only passing testimony that suppliers considered the services they rendered to be “significant” was introduced; and one witness made an enumeration of various services which *could* be performed for customers. There was no testimony of the specific services which were, in fact, performed for petitioners. Consequently, the evidence on this point is not probative and the record certainly does not justify a holding that the cost of such services were “substantial” in relation to the price of feed. *A fortiori* the record does not justify a holding that the *entire* price of the feed constitutes prepayment of services to be rendered in years subsequent to the year of payment.

The inapplicability of cases cited by the Government in its briefs below to support the position that advance payments for services to be performed in subsequent

years were not deductible was adequately covered in petitioners' briefs filed in The Tax Court and are now made a part of these proceedings for the same purpose in the event the Government should choose to rely upon them again in this appeal.

**A. The Tax Court Erred in Not Permitting Petitioners to Deduct "That Portion" of the Price Paid for Feed Which Included Feed Ingredients and Services Performed in the Year of Payment.**

In its opinion the Tax Court repeatedly emphasized that its decision was predicated on the "inclusion of services in the cost of feed to be consumed by petitioners' cattle in the future". But the Court admitted that only "*that portion*" of the cost of feed *attributable to future services* to be rendered was not deductible until the services were performed. (Emphasis added.) At page 17 of the opinion [R. 27] the Court stated:

"And finally, the petitioners' cost of 'feed' included valuable and significant services rendered by both of the cattle feeding companies. *That portion of the cost* was nothing more than a deposit for the payment of services to be supplied in the future. *Such an amount* is deductible only when the services are performed." (Emphasis added.)

Although, in the opinion of The Tax Court, "such amount" was deductible only in the year performed, it denied the deduction of the *entire amount of payments*. Obviously, the Court has made a simple mistake, although a serious one.



If the value of services "to be performed in the future" is to be *excluded* from the price of feed deducted in the year of payment, then it must reasonably follow that the value of services "already performed" must be *included* in such price and is deductible. In the instant case, a great majority of the so-called "substantial" services rendered by sellers were performed PRIOR to the end of the year in which payment was made. Of those services enumerated by The Tax Court [R. 14], all of the unloading, branding, dipping, weighing, de-horning, castrating, recording and placing in pens would have been *performed* IN THE YEAR OF PAYMENT. In this case, the only significant service "to be performed" by the feed sellers would have been the delivery of feed from the storage area to the cattle in the pens.

**B. It Was Error for the Tax Court to Construe Certain Incidental Services Which Suppliers Considered "Significant" as Being "Substantial" in Relation to the Total Price Charged for Feed.**

The feed suppliers testified that they considered certain services which they perform for customers (not *all* of which are furnished to *every* customer) to be "significant". The Tax Court erroneously construed "significant" to mean "substantial"; it compounded this error by assuming that the cost of such services was substantial in relation to the price charged for feed.

Petitioners submit that this fallacy resulted in a conclusion which is clearly a mistake. It also raises an issue as to what constitutes "feed" within the language of §162(a) of the 1954 Code and §1.162-12 of the Regulations thereto. This issue has not been tried.

The books of account of the custom cattle-feeders throughout Imperial Valley will verify the fact that *all* of the services performed for customers do not constitute ten (10%) percent of the total price charged for feed, including ingredients. Although the exact amount of overhead costs which were included in the price of feed charged by Heber and McCabe to petitioners might not be readily available, the cost of ingredients can easily be ascertained from their records. *This point was not considered by The Tax Court or counsel for either side below.*

As a matter of general information, a very small number of cattle are dipped, dehorned or castrated *in the feed yards*. All of petitioners' cattle were steers at the date of purchase and were already in the pens and on feed when they were purchased. Petitioners purchased *All* of their cattle f.o.b. the feeds pens of the custom cattle-feeders, and the freight, delivery and handling costs of any cattle which were "shipped in" for petitioners were billed separately. The petitioners' tax returns reflect these costs as part of the cost of cattle (Exs. 1-A, 2-B, 3-C, 4-D, 5-E, 6-F, 7-G, 8-H, they *Are Not Included* in the payments made for feed. Medical services and supplies were also billed and paid for separately. (Tr. 75, 76.)

Therefore, it is obvious that not *all* of the services referred to by The Tax Court [R. 14] were furnished to petitioners, either in the year of payment or in subsequent years.

The Tax Court decided these cases below solely on the "deposit" theory, and admitted that this theory was adopted because of the inclusion in the price of feed of "services yet to be performed" and the single incident

of a so-called "refund" in 1961 which was not contemplated at the time of payment. The Tax Court stated in its opinion that it is not considering the alternative contention of the Government that to allow the deductions would distort income, but since it has already changed the issue in this case once (without trial of the new issue), petitioners would be remiss in not urging again the arguments set forth in briefs below on that "alternative" issue.

### Conclusion.

Petitioners submit that The Tax Court, by deciding issues which were not tried in these cases and by finding facts which were not supported by the evidence, has demonstrated a great pioneering spirit in attempting to extend the frontier of the Commissioner of Internal Revenue's attack on the use of the cash basis method of reporting income by farmers and livestock feeders.

It is respectfully submitted that petitioners have established that they are entitled to expense deductions for payments made for feed in 1959, 1960 and 1961, and that the Commissioner's disallowance of those deductions, which was upheld by The Tax Court, should be reversed.

Respectfully submitted,

CHARLES A. PINNEY, JR.,  
*Attorney for Petitioners.*

### **Certificate.**

I certify that, in connection with the preparation of this brief, I have examined Rules 18 and 19 of the United States Court of Appeals for the Ninth Circuit, and that, in my opinion, the foregoing brief is in full compliance with those rules.

CHARLES A. PINNEY, JR.





## APPENDIX I.

### EXHIBITS.

(Rule 18(2)(f) of the Rules of the United States  
Court of Appeals for the Ninth Circuit.)

<u>Exhibit Number</u>	<u>Received for Identification</u>	<u>Offered into Evidence</u>	<u>Received into Evidence</u>
Stipulation of facts and joint Exhibits 1-A through 13-N		TR. 3	TR. 3
N	TR. 50	TR. 52	TR. 52
O	TR. 52	TR. 53	TR. 53
P	TR. 90	TR. 91	TR. 91
Q	TR. 90	TR. 91	TR. 91
R	TR. 91	TR. 91	TR. 91
S	TR. 125	TR. 127	TR. 127
T	TR. 126	TR. 127	TR. 127
U	TR. 126	TR. 127	TR. 127

Supplemental  
Stipulation of  
Facts

Filed June 1, 1965 — [R. 8]



IN THE UNITED STATES COURT OF APPEALS  
FOR THE NINTH CIRCUIT

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TIM W. LILLIE and INGEBORG V. LILLIE,

Petitioners

v.

COMMISSIONER OF INTERNAL REVENUE,

Respondent

---

PEARL LILLIE,

Petitioner

v.

COMMISSIONER OF INTERNAL REVENUE,

Respondent

---

ON PETITION FOR REVIEW OF THE DECISIONS OF THE  
TAX COURT OF THE UNITED STATES

---

BRIEF AND APPENDIX FOR THE RESPONDENT

---

FILED

OCT 20 1966

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FOR THE NINTH CIRCUIT

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No. 20915

TIM W. LILLIE and INGEBORG V. LILLIE,

Petitioners

v.

COMMISSIONER OF INTERNAL REVENUE,

Respondent

---

No. 20916

PEARL LILLIE,

Petitioner

v.

COMMISSIONER OF INTERNAL REVENUE,

Respondent

---

ON PETITION FOR REVIEW OF THE DECISIONS OF THE  
TAX COURT OF THE UNITED STATES

---

BRIEF AND APPENDIX FOR THE RESPONDENT

---

OPINION BELOW

The findings of fact and opinion of the Tax Court (I-R. 11-29) 1/  
are reported at 45 T.C. 54.

JURISDICTION

This petition for review (I-R. 33-38) involves federal income  
tax for the taxable years 1956, 1959, 1960 and 1961 in cause number

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1 / "I-R." and "II-R." references are to Volumes I and II of the



20915 (I-R. 30), and for the taxable year 1960 in cause number 20916 (I-R. 32). On August 23, 1963, the Commissioner of Internal Revenue mailed to the taxpayers in cause number 20915 a notice of deficiency for the taxable year 1956 in the amount of \$1,228.88 and negligence penalty of \$61.44; for the taxable year 1959 in the amount of \$4,200 and negligence penalty of \$210.04; for the taxable year 1960 in the amount of \$2,546.69, negligence penalty of \$127.33 and a delinquency penalty of \$254.17; and for the taxable year 1961 in the amount of \$3,552.23 and negligence penalty of \$177.61. Within ninety days thereafter, on October 31, 1963, the taxpayers in cause number 20915 filed a petition with the Tax Court for a redetermination of the deficiency under the provisions of Section 6213 of the Internal Revenue Code of 1954.

On April 1, 1964, the Commissioner of Internal Revenue mailed to the taxpayer in cause number 20916 a notice of deficiency for the taxable year 1960 in the amount of \$7,607.38. Within ninety days thereafter, on May 28, 1964, the taxpayer filed a petition with the Tax Court for a redetermination of the deficiency under the provisions of Section 6213 of the Internal Revenue Code of 1954.

Causes numbers 20915 and 20916, by joint motion of the parties, were consolidated for the purpose of trial and briefing. Decisions of the Tax Court were entered on January 20, 1966. (I-R. 30-32.) The case is brought to this Court by a petition for review filed March 2, 1966 (I-R. 33-38), within the three-month period prescribed in Section 7483 of the Internal Revenue Code of 1954. Jurisdiction is conferred on this Court by Section 7482 of that Code.

### QUESTION PRESENTED

Whether the Tax Court correctly sustained the Commissioner's determination that large end-of-year payments by taxpayers for feed to be consumed and services to be rendered subsequent to the years of payment were not deductible as ordinary and necessary business expenses in the years of payment, but only in the years in which the feed and services were supplied.

### STATUTE AND REGULATIONS INVOLVED

The pertinent provisions of the Statute and Regulations involved are set out in the Appendix, infra.

### STATEMENT

Tim W. and Ingeborg V. Lillie are husband and wife, residing in San Diego County, California. Pearl Lillie, mother of Tim, also resides in San Diego County, California. (I-R. 12-13.) 2/

Taxpayers keep their books and prepare their federal income returns on a calendar year basis and on the cash receipts and disbursements method of accounting. For the taxable years 1956 through 1961, the taxpayers filed their federal income tax returns with the District Director of Internal Revenue at Los Angeles, California. (I-R. 13.)

Tim is a dentist, and during the years in issue had a successful practice in the San Diego area. He reported net income from his dental practice as follows (I-R. 13):



<u>Year</u>	<u>Amount</u>
1956	\$26,778.25
1957	31,490.72
1958	28,058.91
1959	24,647.67
1960	10,244.54
1961	19,115.32

Tim reported net losses from a cattle business as follows (I-R. 13):

<u>Year</u>	<u>Amount of net (loss)</u>
1959	\$(29,176.83)
1960	(18,458.46)
1961	(6,683.84)

Tim's aggregate net income from his dental practice for the years 1959 through 1961 was approximately \$54,000 and his aggregate net loss from his cattle business for the same years was also approximately \$54,000. (I-R. 13.)

Pearl reported income in 1960 of \$21,226.93, which included interest payments received from Tim in the amount of \$18,444. On her 1960 federal income tax return she reported a net loss from cattle operations in the amount of \$20,402.12 of which \$19,700 was due to cattle feeding payments. (I-R. 14.)

During the years 1959, 1960, and 1961 Tim fed cattle for profit in Imperial County, California. Pearl joined him in his venture in 1960 and both have been actively engaged in the cattle business ever since. (I-R. 14.)

The cattle owned by taxpayers during these years were physically located in the commercial feed yards of Heber Cattle Feeders, 3/

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3 / Hereinafter referred to as Heber.

Heber, California, and McCabe Cattle Company, 4/ on the Dahlia Canal near El Centro, California. McCabe and Heber are cattle servicing companies whose principal source of income is derived from the sale of cattle feeds and services to their customers. To increase sales, these companies perform such complete services that some cattle owners never see their stock. McCabe and Heber purchase cattle for their customers and direct shipment to the company yards. When the cattle arrive, they are unloaded, branded, dipped, and weighed. Bulls are dehorned and castrated. The cattle are also recorded and placed in proper feeding pens. Throughout the months during which the cattle are being fattened, company employees mix the proper feeds and deliver them to the herds twice daily. After sale, the companies load the cattle and direct shipment to the purchasing meat packing houses.

(I-R. 14.) The value of the services rendered by the cattle feeding companies is substantial, but, rather than reflect them as such when billing customers, they have developed the general practice of including the cost of services in the sales price of their feeds.

(I-R. 15.)

The most frequently used feeds are silage, a basic feed used in the early growing stages, and finishing mixes, a name given to various blends of feed used to fatten steers to their maximum weight. The contents of these finishing feeds vary from company to company and can generally be said to grow more expensive as they contain those

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4/ Hereinafter referred to as McCabe.



elements which add the greatest finishing weight to the steer. (I-R. 15.)

Between December 13, 1959, and August 21, 1960, Tim maintained at Heber a herd of varying size which was identified as Lot No. 2. On December 21, 1959, Tim made a payment of \$25,000 to Heber and received as invoice reading, in part, as follows (I-R. 15):

\* \* \* for your purchase of the five hundred (500) tons of Number 1 feed for the cattle which you have placed with us to feed in our Lot #2 here at Heber Cattle Feeders.

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\*

So that you may inform your bookkeeper or accountant of your transactions here in El Centro and Heber, I am listing below your account as of this date with us:

Feed (paid). . . 500 tons, #1 mix. . . \$25,000.00  
(Stored in east warehouse - Heber)

By December 31, 1959, Tim's cattle had consumed at Heber only \$657.65 of feed. During the year 1960 the cattle fed at Heber consumed \$32,704.74 of feed and Tim paid an additional sum of \$8,362.39 to Heber. (I-R. 15.)

Between November 14, 1960, and May 13, 1961, Tim maintained at McCabe two herds of varying size which were identified as Lots 117 and 137. On November 18 and December 31, 1960, Tim made payments of \$15,000 and \$27,160 respectively to McCabe, who recorded these amounts as feed sold to Tim in its books. The cattle in Lots 117 and 137 consumed \$3,244.59 of feed in 1960 and \$12,774.84 of feed in 1961 before being sold. (I-R. 16.)

During 1961, Tim had a disagreement with the managers of McCabe. Since he thought he could obtain more favorable treatment at Heber, he decided to transfer all of his business there. Consequently, on or about July 10, 1961 (some two months after the last of the cattle in Lots 117 and 137 had been sold), McCabe gave Tim a check for \$26,140.57 which represented the difference between Tim's payments (totaling \$42,160) and the total amount (\$16,009.94) of feed consumed by Lots 117 and 137 during 1960 and 1961. 5/ The termination of transactions between Tim and McCabe had not been envisioned the previous December when he had made his advance payments. No provision for the refund of the sums paid by Tim in November and December of 1960 had been made with McCabe. The check issued by McCabe represented the "credit balance due and payable" to Tim as shown on McCabe's statement of account dated July 10, 1961. (I-R. 16.)

Between July 5, 1961, and January 29, 1962, Tim maintained at Heber a herd of varying size which was identified as Lot No. 1. Between November 8, 1961, and May 14, 1962, he kept an additional herd at Heber which was identified as Lot No. 3. On December 29, 1961, Tim made a payment of \$52,520.23 to Heber. The cattle in Lots 1 and 3 consumed \$10,344.01 of feed in 1961. The balance of \$42,176.22, which was credited to Tim's account on December 31, 1961, was used for feed and services supplied in 1962. (I-R. 17.)

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5/ An additional \$9.49 was charged against Tim's payment as the fee for a branding inspection. (I-R. 16.)



On December 31, 1960, Pearl owned approximately 133 head of cattle which were identified as Lot 144 at McCabe. On December 9, 1960, and December 30, 1960, Pearl made payments of \$5,000 and \$14,700 respectively to McCabe and these payments were recorded as sales of feed on McCabe's books. Pearl's cattle consumed \$495.25 worth of feed during 1960 and \$4,822.01 in 1961. Pearl joined Tim when he transferred his entire cattle business to Heber in 1961 and, as a result of this change, a check for \$14,382.74 (the difference between Pearl's December 1960, payments and the total feed consumed by her cattle) was drawn by McCabe to Pearl on July 14, 1961. No provision for refund had been made with McCabe in December, 1960. Pearl continued to raise cattle at the facilities of Heber during the remainder of 1961. (I-R. 17.)

Taxpayers received monthly statements from Heber and McCabe which showed the cost of the feed consumed by their cattle. The cost was charged against their credit balances, which equalled the end-of-year payments less monthly charges. (I-R. 17-18.)

Taxpayers were not required to pay for feed in advance of consumption; nor did they secure any volume discounts, price advantage or preferential treatments from Heber to McCabe because of the large end-of-year payments. Customers of Heber and McCabe could pay monthly for the cost of feed consumed by their cattle and many of them did so. Furthermore, taxpayers were charged for feed consumed at the same price as were all other customers independent of their feeding arrangement. The end-of-year payments made by taxpayers to Heber and McCabe did not secure for them specific quantities or types of feed, nor any other

business advantage. (I-R. 18.) The only advantage sought by taxpayers by the large end-of-year payments was a tax saving. (I-R. 18.)

The price charged for feed by both Heber and McCabe included the cost of extensive and valuable services rendered by the cattle feeding companies. (I-R. 18.)

In his federal income tax returns, Tim claimed the end-of-year payments as ordinary and necessary business expense deductions in the years of payment as shown in the following schedule (I-R. 18-19):

	<u>1959</u>	<u>1960</u>	<u>1961</u>
Cattle sales		\$67,575.24	\$118,135.46
Less-cost of cattle sold		(30,710.41)	(64,705.14)
Gross profit		36,864.83	53,430.32
Less-all expenses (except feed)	\$(4,176.83)	(4,800.90)	(7,114.16)
Profit (loss) before feed expenses claimed	(4,176.83)	32,063.93	46,316.16
Feed expense claimed	(25,000.00)	(52,522.39)	(53,000.00)
Net loss claimed	\$(29,176.83)	\$(18,458.46)	\$(6,583.84)

The net profit computed on the basis of actual feed costs is as follows (I-R. 19):

	<u>1959</u>	<u>1960</u>	<u>1961</u>
Cattle sales		\$67,575.24	(118,135.46
Less-cost of cattle sold		(30,710.41)	(64,705.14)
Gross profit		36,864.83	53,430.32
Less-all expenses (except feed)	\$(4,176.83)	(4,800.90)	(7,114.16)
Profit (loss) before feed expense	(4,176.83)	32,063.93	46,316.16
Feed expense (feed actually consumed)	(657.65)	(35,949.33)	(23,118.85)
Net profit (loss)	\$(4,834.48)	\$(8,885.40)	\$23,197.31



In his notices of deficiencies to the taxpayers, the Commissioner disallowed the end-of-year payments as deductions in the years paid except for small amounts for feed actually consumed in the years of payment. The deductions, however, were allowed by the Commissioner in the years the feed was consumed and the feeding services rendered. (I-R. 21.)

The Tax Court in a decision reviewed by the full court, unanimously held that the end-of-year payments made to the cattle feeding companies were merely deposits for the purchase of feed and related services to be supplied in subsequent years, and did not constitute current expenses for feed and services. (I-R. 19, 28.) The Tax Court, therefore, accordingly held that the end-of-year payments could not be treated as expenses deductible in the years made, but were deductible as ordinary and necessary business expenses only in the years of their use in defraying the cost of feed and other services. (I-R. 28.)

This petition for review followed.

#### SUMMARY OF ARGUMENT

Section 162(a) of the Internal Revenue Code of 1954 allows as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business. Even if an expenditure otherwise qualifies as an ordinary and necessary business expense, where (as here) a taxpayer files his returns on the cash method of accounting, the expense is deductible only in the taxable year in which it is "paid". A claimed business expense deduction will therefore be allowable only if the amount is paid for an actual expense of the business for the taxable year involved.

The large end-of-year "payments" made by taxpayers for feed to be supplied and services to be rendered in the future failed to meet the above tests for deductibility because, as the Tax Court unanimously concluded, they were merely deposits against which future expenses would be charged, and therefore did not represent payments for current expenses. The record reveals, as the Tax Court found, that the end-of-year disbursements were not made pursuant to any specific quality or quantity of feed; that they were refundable, and in fact were in substantial part refunded; that a significant portion of the cost of feed was for services to be rendered in the future; and that they did not secure for the taxpayer any business advantage, but only a hoped-for reduction in taxable income. These factors, viewed singly or in combination, fully warrant the Tax Court's determination that the payments in question in reality constituted deposits against future expenses, not current business expenses attributable to the taxable year in which they were claimed as deductions, and were deductible only in the years when the feed and services were supplied.

The decision below is entitled to affirmance on the alternative ground that to allow the taxpayer to deduct the "payments" in the years made, rather than in the years in which the feed was consumed and the services were rendered, would distort, rather than clearly reflect their incomes (as required by Sections 446 and 461 of the Internal Revenue Code of 1954), for the taxable years here involved.

The Tax Court's decision is in accord with the relevant decisions. The cases upon which taxpayers rely are readily distinguishable for the reasons pointed out by the Tax Court.



## ARGUMENT

THE TAX COURT CORRECTLY HELD THAT LARGE END-OF-YEAR PAYMENTS BY TAXPAYERS FOR FEED TO BE CONSUMED AND SERVICES TO BE RENDERED IN SUBSEQUENT YEARS WERE NOT DEDUCTIBLE EXPENSES IN THE YEARS OF PAYMENT

### A. Introduction

The Tax Court in a decision reviewed by the full court unanimously held that large end-of-year payments made by taxpayers to cattle feeding companies were not deductible expenses incurred in the years of payment as claimed by taxpayers, but were, as determined by the Commissioner, deductible only in the years in which the feed was consumed and the services rendered. 6/ The determination of the Tax Court was based on the factual finding that the amounts placed in the hands of the cattle feeding companies near the end of each of the years in question were in reality merely deposits and did not constitute actual expenses for feed and services for those years. The Commissioner submits that the decision below should be affirmed on that ground or alternatively on the ground that, as additionally urged by the Commissioner below, but not passed upon by the Tax Court (I-R. 28-29), allowance of the claimed deductions would materially distort taxpayers' income in the years in question.

### B. A deposit for the payment of feed and related services is not a current business expense and therefore may not be deducted from current taxable income

The Tax Court's holding that deposits for payment of future purchases of feed and related services could not be deducted in the years

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6/ Thus, a deduction in the year of payment was allowed for the small amount of feed and services actually supplied in that particular year. For example, a \$25,000 payment was made in December, 1959, by Tim to Heber whereas his cattle consumed only \$657.65 worth of feed at Heber's in 1959. (I-R. 2.) Only the latter amount was allowed by the Commissioner as a deduction in 1959.

in which they were made is completely consistent with Sections 162, 446 and 461 of the Internal Revenue Code of 1954 (Appendix, infra), as well as the decided cases considering the point. 7/

Section 162 of the 1954 Code provides:

SEC. 162. TRADE OR BUSINESS EXPENSES.

(a) In General.--There shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including--

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(26 U.S.C. 1964 ed., Sec. 162.)

These words clearly state that a deduction will be allowed only if the amount paid is for an actual expense of the trade or business. If an amount is paid as a deposit against future expenses, it does not meet the test - it is not paid for a current expense. 8/ The burden of proof is on the taxpayer to show that he has incurred a deductible

7/ The courts have not looked favorably on attempts by cash basis taxpayers to deduct advance payments (to say nothing of mere deposits) for expenses of subsequent years. See for example Main & McKinney Bldg. Co. v. Commissioner, 113 F. 2d 81 (C.A. 5th), certiorari denied, 311 U.S. 688; Baton Coal Co. v. Commissioner, 51 F. 2d 469 (C.A. 3d), certiorari denied, 284 U.S. 674; Galatoire Bros. v. Lines, 23 F. 2d 676 (C.A. 5th); Commissioner v. Boylston Market Ass'n, 131 F. 2d 966 (C.A. 1st); Peters v. Commissioner, 4 T.C. 1236; and Automatic Fire Alarm Co. v. Commissioner, 13 B.T.A. 1195.

8/ Section 162 is intended primarily to cover expenditures of a recurring nature where the benefit derived from the payment is realized or exhausted within the taxable year. Accordingly, if as the result of the expenditure, a taxpayer acquires an asset which has an economically useful life beyond the taxable year, no deduction for such payment is allowable as a business expense. See 4A Mertens, Law of Federal Income Taxation, Section 25.20, and the citations contained therein. Moreover, even though an expenditure may result in the acquisition of an asset which has a life of less than one year, it may nevertheless not be deductible if not paid or incurred in currently carrying on the taxpayer's business and if not both ordinary and necessary to the current conduct of such business. General Bancshares Corp. v. Commissioner, 326 F. 2d 712 (C.A. 8th), certiorari denied, 379 U.S. 832.



expense (Interstate Transit Lines v. Commissioner, 319 U.S. 590, 593; E.&J. Gallo Winery v. Commissioner, 227 F. 2d 699 (C.A. 9th)) and the determination whether these expenditures are ordinary and necessary business expenses is a question of fact (Commissioner v. Heininger, 320 U.S. 467). As stated by the United States Court of Appeals For the First Circuit in Russell Box Co. v. Commissioner, 208 F. 2d 452, 454:

When all is said, the fact remains that close cases have to be decided by the Tax Court one by one as individual instances, and that our function is to reverse the Tax Court only when we are concerned that its conclusion in a particular case is clearly erroneous.

See also Wohl v. United States, 267 F. 2d 605 (C.A. 5th), certiorari denied, 361 U.S. 931; Wells-Lee v. Commissioner, 360 F. 2d 665 (C.A. 8th).

We submit that the record amply supports the Tax Court's unanimous conclusion that the end-of-year "payments" were merely deposits and therefore not deductible as expenses of the year in which they were made.

First, as found by the Tax Court, the advance payments did not secure for the taxpayers any business advantage other than a substantial reduction in taxable income.<sup>9/</sup> (I-R. 18.) This reduction resulted from the offsetting of large amounts of income received from other sources<sup>10/</sup> by large losses

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<sup>9/</sup> Taxpayers now admit that one of the reasons for making the end-of-year payments was to obtain the tax advantage. (Br. 18.) Earlier, Tim had denied that in making the large end-of-year payments, the tax aspect was considered at all. (II-R. 28-29.) Pearl likewise denied that the tax aspect was considered. (II-R. 142-143.)

<sup>10/</sup> In the case of Tim, the source was his dental practice. (I-R. 13.) Whereas, in the case of Pearl, it was interest payments from Tim. (I-R. 14.)

incurred in the cattle-feeding business (I-R. 13-14), which losses were primarily due to the taking of deductions for feed expenses in the year payments were made, rather than in the year the feed was consumed (I-R. 19). Taxpayers suggest that a price advantage was obtained by making the payments. However, the Tax Court specifically found that the taxpayers received no price advantage by making the end-of-year payments during the year in issue,<sup>11/</sup> that no volume discount was received by virtue of the payments,<sup>12/</sup> that customers of Heber and McCabe could pay monthly for the cost of feed consumed by their cattle and many did so,<sup>13/</sup> that taxpayers were not required to pay for feed in advance of consumption<sup>14/</sup> and that taxpayers were charged for feed consumed at the same price as were all other customers independent of their feeding arrangements.<sup>15/</sup> (I-R. 18.) Nor was any preferential treatment given taxpayers because of the end-of-year payments.<sup>16/</sup> (I-R. 18.) Moreover, the Tax Court found that no business reason existed for making the advance payments and also found that there was no shortage of feed when the end-of-year payments were made. (I-R. 18, 27.)

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<sup>11/</sup> See testimony. (II-R. 78-102.)

<sup>12/</sup> Tim so testified (II-R. 31) and Jack William, manager of McCabe, so testified (II-R. 113).

<sup>13/</sup> Virgil Torrence, a partner and general manager of Heber, so testified (II-R. 68), and Jack William so testified (II-R. 112-113.)

<sup>14/</sup> See testimony of Virgil Torrence. (II-R. 68-69.)

<sup>15/</sup> See testimony (II-R. 78-102) and the Supplemental Stipulation of Facts (I-R. 8-10).



Second, taxpayers purchased no specific quality or quantity of feed. Rather, as the various feeds were used, the current market prices for the feeds consumed were charged against taxpayers' then existing credit balances.<sup>17/</sup> (I-R. 27.) For example, on December 21, 1959, Tim made a payment of \$25,000 to Heber and received an invoice which stated that he had purchased 500 tons of Number 1 mix. (I-R. 15.) However, from December, 1959 to March, 1960, Tim's cattle consumed approximately 59 tons of number 1 mix, 12 tons of number 2 mix, 117 tons of number 4 mix, and 136 tons of silage. The costs of these different types of feed (which varied from \$12 to \$50 per ton) were charged against the \$25,000 payment. Moreover, medical supplies were also charged against the \$25,000. (Ex. 10-J; II-R. 39-44.)

That the end-of-year payments did not represent payment for any specific quality or quantity of feed is further shown by the end-of-year payment made in 1961 in the amount of \$52,520.23; which Tim took as a deduction in 1961. (I-R. 17, 19.) During the years 1961 and 1962, taxpayers were on the "pounds gained by cattle" method of payment to the cattle feeders. (Ex. 11-K; II-R. 47-49.) This was a method whereby the cattle feed companies charged their customers a specific price per pound for each pound gained by the customer's cattle. (II-R. 89.) Heber charged Tim for the weight so gained and applied such charge against the \$52,520.23 payment which taxpayers claim was for the purchase of a specific quality and quantity of feed.<sup>18/</sup> That the \$52,520.23 payment

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<sup>17/</sup> Credit balances were the amount of the end-of-year payments less subsequent monthly charges. (I-R. 18.)

<sup>18/</sup> The fact that taxpayers and the cattle feeding companies treated the transaction on their books as sales is not controlling. The real facts, not bookkeeping entries, must control the determination of taxable income. Doyle v. Mitchell Brothers Co., 247 U.S. 179.

in December, 1961, did not represent the purchase of feed could not be made clearer.

Third, during 1961, Tim had a disagreement with the manager of McCabe where he had been maintaining two herds of varying size. He then decided to transfer all of his business to Heber. Consequently, on or about July 10, 1961 (some two months after the last of the cattle which had been kept at McCabe had been sold), McCabe gave Tim a check for \$26,140.57, which represented the difference between Tim's end-of-year payments in 1960 of \$42,160 and the amount of feed (\$16,009.94) consumed by his cattle at McCabe.<sup>19/</sup> (I-R. 16.) If taxpayers' argument that the end-of-year "payments" were deductible in the year paid were accepted, it would result in Tim understating his income for 1961 in the amount of \$26,140.57; i.e., the amount of the refund from McCabe. This understatement of income results from the fact that in 1960, Tim took a deduction of \$42,160 for the end-of-year payments in that amount. (I-R. 16, 18.) Included in the payments was the \$26,140.57 which McCabe subsequently refunded to Tim. Then, in 1961, Tim took a further deduction for end-of-year "payment" in the amount of \$53,000 (I-R. 19) which was composed of \$52,520.23 paid to Heber in 1961 and \$479.77 paid to McCabe that same year (I-R. 4). Nowhere, however, did Tim report or in any manner reflect the return of the \$26,140.57 for which a deduction had been taken in the prior year, 1960. (Ex. 8-H.) Tim therefore grossly overstated his

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<sup>19/</sup> An additional \$9.49 was charged against Tim's payment as the fee for a branding inspection. (I-R. 16.)



cost of feed in 1960, or else understated his income for 1961 (even assuming the end-of-year payments to be deductible in the year made).<sup>20/</sup> If the decision of the Tax Court is upheld, the return of the \$26,000 would be considered merely as the return of a deposit, with no resulting overstatement of deductions in one year or understating of income in a subsequent year.

Moreover, the very fact that the deposits were refunded in one out of three tax years with which Tim is concerned and in the only tax year with which Pearl is concerned negates taxpayers' claim that the end-of-year payments represented payments for completed sales; for, if there had actually been payments for sales of feed involved rather than deposits, the amount refunded to taxpayers by McCabe should have been less than their credit balances. This is so because if McCabe were purchasing back feed previously sold to the taxpayers, it would not have paid as much as did the taxpayers since the taxpayers would have purchased both feed and services whereas McCabe would be purchasing back only feed. McCabe, however, "paid" the taxpayers the full amount of their credit balances remaining on its books, clearly indicating thereby that McCabe was merely returning taxpayers' deposits.

Fourth, a substantial portion of the end-of-year payments was for services to be rendered in the subsequent year, and hence represented merely deposits against which future charges for such services could be made. The cost of feed included the cost of substantial services rendered by the cattle feeding companies. The services were performed in order

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<sup>20/</sup> Pearl received a refund in 1961 from McCabe in the amount of \$14,382.74. (I-R. 17.) The tax treatment in that year of the amount so refunded is not in question as only Pearl's 1960 tax year is involved in this case.

to increase sales of feed and were in fact so complete that some cattle owners never saw their stock. Among the services performed by the cattle feeding companies were unloading, branding, dipping, weighing, dehorning, castrating, recording and placing the cattle in proper feeding pens. Throughout the months during which the cattle were being fattened, company employees would mix the proper feeds and deliver them to the herds twice daily. After sale, the feeding companies would load the cattle and direct shipment to the meat packing houses. (I-R. 14.) Thus, services were being rendered throughout the entire period in which the cattle were at the cattle feeding company, and a substantial part of the advance "payments" in question was for future services.

Taxpayers place great reliance on the cases of Ernst v. Commissioner, 32 T.C. 181, and Cravens v. Commissioner, 272 F. 2d 895 (C.A. 10th). We submit, as the Tax Court found, that Ernst and Cravens are factually distinguishable from the instant case. (I-R. 27.)

In Ernst, the taxpayer was a poultry farmer who made substantial payments in 1948 and 1949 to a grain dealer who became obligated to deliver quantities of chicken feed to the taxpayer during the succeeding years. The payments were for the purchase of a certain number of cars of feed and bags of scratch, the price of which was to be adjusted at the date of shipment. Deliveries were made by the grain dealer in the early months of 1949 and 1950, at which time charges were made against the taxpayer's account receivable card. The charges were determined by the quantity of the deliveries and the prevailing price on the weekly wholesale price list. The taxpayer had no right to a return of any of the payments made. On these facts, the payments were held to be deductible in the years of payment.



Several factors distinguish the instant case from Ernst.

First, taxpayers here actually received a refund of the deposits, whereas, in Ernst, the taxpayer had no right to a return of any of the payments made.

Second, the price of feed in the present case included the cost of a significant amount of services to be rendered in the future (including the feeding of the cattle) whereas, in Ernst the poultry was fed on the taxpayer's own farm and no services were rendered by the supplier of the feed.

Third, the payments in Ernst were for the purchase of a certain number of cars of feed and bags of scratch. In the instant case, no specific quantity and quality of the feed was "purchased" by virtue of the deposits. (I-R. 18.) Rather, various mixes, silage and alfafa were charged against the deposit, as were also medical supplies. Furthermore, in those years where taxpayers were on the "pounds gained by cattle" method, the costs so incurred by taxpayers were charged against the end-of-year payments which supposedly were, as argued by taxpayers, solely for the purchase of feed. These costs were, however, for the increased value of the cattle (as represented by their gain in weight) and could hardly be considered to be for the cost of feeds.

Fourth, in Ernst the taxpayer's primary source of income was from his poultry farm and the deduction for feed in the year of payment did not materially distort his income. Here, Tim's primary source of income was his dental practice (I-R. 13) and Pearl's primary source was interest payments from Tim (I-R. 14). The effect of the deductions being taken

in the year the payments were made, rather than in the year the feed was consumed and the services rendered, was to totally offset Pearl's interest income and to enable Tim to report large losses which offset substantial amounts of income from his dental practice. (I-R. 13-14.)

Likewise, Cravens v. Commissioner, supra, is distinguishable from the instant proceeding. In Cravens, the taxpayer operated a cattle ranch. In 1953, because of a drought and an impending shortage of cattle feed, the taxpayer gave his feed supplier \$50,000 as an advance payment on 745 tons of feed. Delivery was to be made as the taxpayer placed his orders, and the price was to be the market price prevailing on the delivery dates. If the advance payment exceeded the ultimate cost, the taxpayer was entitled to a refund. The feed supplier was unable to guarantee delivery, but did agree to fill the taxpayer's order first in the event of shortages. A deduction for 1953 in the amount of \$50,000 was upheld by the Court of Appeals for the Tenth Circuit.

Several factors also distinguish the present case from Cravens.

First, the primary basis for the decision in Cravens appears to be that the taxpayer there had a compelling business reason in that a drought threatened to terminate his supply of feed and the payment secured preferential treatment for him. No such need or preferential treatment has been shown in the present case. In fact, the Tax Court specifically found that there was no shortage of feed (I-R. 27) and that the end-of-year payments secured no preferential treatment for taxpayers (I-R. 18).



Second, in Cravens the cost of feed did not include the value of services, as the cattle were feed at the taxpayer's ranch. Here, the taxpayers' cost of feed included valuable and significant services to be rendered by both of the cattle feeding companies. Thus, a portion of the deposit was in essence a deposit for the payment of services to be supplied in the future.

Third, the taxpayer in Cravens never received a refund or return of his payment, whereas, these taxpayers received what amounted to substantial refunds.

Fourth, in Cravens the taxpayer ordered a specific quantity of feed. Here, the taxpayers in actuality did not order a specific quantity, but, were charged for various feeds and mixes as they were consumed by the cattle. Furthermore, medical supplies were charged against the payments which taxpayers now claim to have been solely for feed. And, when it is noted that the advance payments or deposits continued when taxpayers were on the "pounds gained by cattle" method of paying for the feeding and servicing of their cattle, it becomes quite clear that the end-of-year payments were not for the purchase of specific quantities of feed.

In rejecting taxpayers' claim that Ernst and Cravens are controlling, the Tax Court stated (I-R. 28):

Notwithstanding petitioners' heavy reliance on Ernst and on the Tenth Circuit's opinion in Cravens, we lack the pioneering spirit to extend the frontier of the factual conclusions reached in those decisions to cover the different facts before us in these cases. Suffice it to say that neither Ernst nor Cravens is controlling here.

In Shippy v. United States, 308 F. 2d 743 (C.A. 8th), the latest case on this particular subject, the taxpayers were members of a partnership engaged in a cattle and hog feeding business with income being reported on the cash basis. On December 28, 1957, the partnership made a \$23,000 payment to a grain elevator operator for feed to be delivered in the future as needed by the partnership in its feeding operations. Feed was supplied to the partnership from time to time in 1958, at the price in effect on the date of each delivery, until the entire \$23,000 was exhausted in July of that year. The District Court (199 F. Supp. 842 (W.D. S.D.)) held the payment was not an ordinary and necessary business expense in 1957 (the year of payment), but an advance deposit to cover future purchases of grain. In so holding, the District Court stated (p. 843):

\* \* \* this large advance deposit for future delivery of feed could hardly be termed "ordinary." Neither was it "necessary." The reasons advanced by the partnership as to the necessity of the advance deposits are not convincing. There was no shortage of feed. Advance payment was not and never had been demanded by the elevator. The elevator's commission paid by the partnership was the same as it had always paid, and the advance deposit assured it of no preferential treatment it could not have had without such deposit.

The arrangement made between the partnership and the elevator was not a contract. It was an advance deposit for future purchases of feed. We do not believe that Congress intended that taxpayers should be allowed to "juggle" their liability in this manner.



In affirming the decision of the District Court, the Court of Appeals for the Eighth Circuit stated (supra, pp. 747-748):21/

\* \* \* the partnership did not have a binding contract to purchase wet corn or other grain. It did not actually buy grain. It made only an advance deposit which would have been refunded upon request. Therefore, the disbursement was not an ordinary and necessary expense paid in the year 1957 in the carrying on of its trade or business.

In commenting on the Shippy decision, the Tax Court in the instant proceeding stated (I-R. 28):

We believe these facts [in the instant case] present a stronger case than Shippy, except for the specific finding in that case that the seller considered the payment a deposit. Again we emphasize the inclusion of services in the cost of feed to be consumed by petitioners' cattle in the future and the sizeable refunds received by both petitioners from McCabe in 1961.

The Commissioner is in full agreement with the Tax Court that this case presents a stronger case for the Government than did Shippy; for, as in Shippy, quantity, quality and price of the feed to be consumed by taxpayers' cattle were unknown at the time the payments were made. However, in Shippy the cost of feed did not, as it did here, include services to be rendered by the feeding companies; the taxpayer in Shippy did not obtain any refund as did taxpayers here; and as the feed company in Shippy was not performing any services, the cost of "pounds gained by cattle" could not be, as was the case here, charged against the end-of-year payment.

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21/ The Court of Appeals deemed it unnecessary to reach and discuss alternative grounds upon which the District Court based its decision.

C. Allowance of the claimed deductions in the years of payment would materially distort taxpayers' net incomes for those years

As stated in the Introduction (Part A, supra), the decision below is entitled to affirmance on the alternative ground that allowance of the claimed deductions in the years of "payment" would materially distort taxpayers' net incomes for those years.<sup>22/</sup> And, as pointed out above (Part B) in support of the Tax Court's conclusion that the "payments" in reality represented deposits against future purchases and services, a substantial part of which was refunded in a later year, to sanction the claimed deductions would distort taxpayers' incomes--either by an overstatement of deductions in the year of payment, or an understatement of income in the year of refund.

Indeed, taxpayers' incomes here were distorted to a greater degree than in Shippy. In that case, if the payment had been allowed as a deduction in the year in which it was paid, the taxpayer's income over a period of years would have been \$5,000, \$24,000, \$12,000 (year of payment) and \$8,000; whereas, when the payment was disallowed as a deduction in the year paid, the taxpayer's income was \$5,000, \$24,000, \$35,000 (year of payment) and (\$15,000). In the present case, Tim's income from his dental practice was as follows (I-R. 13):

<u>Year</u>	<u>Amount</u>
1956	\$26,778.25
1957	31,490.72
1958	28,058.91
1959	24,647.67
1960	10,244.54
1961	19,115.32

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<sup>22/</sup> The Commissioner urged this alternative ground below, but the Tax Court considered it unnecessary to pass upon it in view of its conclusion that the payments did not constitute currently deductible business expenses. (I-R. 28-29.)



His reported losses from the cattle business, which resulted primarily from taking deductions for the end-of-year payments in the year paid rather than in the year when the feed was consumed and the services rendered were as follows (I-R. 13):

<u>Year</u>	<u>Amount of net (loss)</u>
1959	(\$29,176.83)
1960	(18,458.46)
1961	(6,683.84)

If, however, the cost of feed had been computed on the basis of actual feed costs, the net profit from Tim's cattle business would have been as follows (I-R. 19):

<u>Year</u>	<u>Amount of net (loss)</u>
1959	(\$4,834.48)
1960	(3,885.40)
1961	23,197.31

The same situation exists in Pearl's case. In her 1960 federal income tax return, she reported income of \$21,226.93 which included interest payments received from Tim in the amount of \$18,444. At the same time, she reported a net loss from her cattle operation in the amount of \$20,402.11 of which \$19,700 was due to end-of-year payments made in December of 1960. (I-R. 14.) Thus, Pearl likewise timed the large end-of-year payment so as to attempt to offset the large interest payment received from Tim that same year.

In short, end-of-year payments were ordinary and necessary business expenses only for those years in which the feed was consumed and the service rendered - and were allowed as deductions for those years. They

were properly disallowed as deductions in the years of payment either on the ground that the payments merely represented deposits and as such were not ordinary and necessary expenses within the meaning of Section 162 for the taxable years in which paid or, alternatively, on the ground that the deductions resulted in a distortion of taxpayers' incomes and therefore failed to clearly reflect income as required by Sections 446 and 461 of the Internal Revenue Code of 1954 and Sections 1.461-1(a)(1) and (3)(i) of the Treasury Regulations (Appendix, infra).

#### CONCLUSION

The decision of the Tax Court is correct and should be affirmed.

Respectfully submitted,

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OCTOBER, 1966.

#### CERTIFICATE

I certify that, in connection with the preparation of this brief, I have examined Rules 18, 19 and 39 of the United States Court of Appeals for the Ninth Circuit, and that, in my opinion, the foregoing brief is in full compliance with those rules.

Dated: \_\_\_\_\_ day of \_\_\_\_\_, 1966.

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Attorney



APPENDIX

Internal Revenue Code of 1954:

SEC. 162. TRADE OR BUSINESS EXPENSES.

(a) In General.--There shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including--

(1) a reasonable allowance for salaries or other compensation for personal services actually rendered;

\*

\*

\*

(26 U.S.C. 1964 ed., Sec. 162.)

SEC. 446. GENERAL RULE FOR METHODS OF ACCOUNTING.

(a) General Rule.--Taxable income shall be computed under the method of accounting on the basis of which the taxpayer regularly computes his income in keeping his books.

(b) Exceptions.--If no method of accounting has been regularly used by the taxpayer, or if the method used does not clearly reflect income, the computation of taxable income shall be made under such method as, in the opinion of the Secretary or his delegate, does clearly reflect income.

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(26 U.S.C. 1964 ed., Sec. 446.)

SEC. 461. GENERAL RULE FOR TAXABLE YEAR OF DEDUCTION.

(a) General Rule.--The amount of any deduction or credit allowed by this subtitle shall be taken for the taxable year which is the proper taxable year under the method of accounting used in computing taxable income.

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(26 U.S.C. 1964 ed., Sec. 461.)

Treasury Regulations on Income Tax (1954 Code):

Sec. 1.461-1 General rule for taxable year of deduction.

(a) General rule.--(1) Taxpayer using cash receipts and disbursements method. Under the cash receipts and disbursements method of accounting, amounts representing allowable deductions shall, as a general rule, be taken into account for the taxable year in which paid. Further, a taxpayer using this method may also be entitled to certain deductions in the computation of taxable income which do not involve cash disbursements during the taxable year, such as the deductions for depreciation, depletion, and losses under sections 167, 611, and 165, respectively. If an expenditure results in the creation of an asset having a useful life which extends substantially beyond the close of the taxable year, such an expenditure may not be deductible, or may be deductible only in part, for the taxable year in which made. An example is an expenditure for the construction of improvements by the lessee on leased property where the estimated life of the improvements is in excess of the remaining period of the lease. In such a case, in lieu of the allowance for depreciation provided by section 167, the basis shall be amortized ratably over the remaining period of the lease. See section 178 and the regulations thereunder for rules governing the effect to be given renewal options in determining whether the useful life of the improvements exceeds the remaining term of the lease where a lessee begins improvements on leased property after July 28, 1958, other than improvements which on such date and at all times thereafter, the lessee was under a binding legal obligation to make. See section 263 and the regulations thereunder for rules relating to capital expenditures.

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\*

(3) Other factors which determine when deductions may be taken. (i) Each year's return should be complete in itself, and taxpayers shall ascertain the facts necessary to make a correct return. The expenses, liabilities, or loss of one year cannot be used to reduce the income of a subsequent year. A taxpayer may not take advantage in a return for a subsequent year of his failure to claim deductions in a prior taxable year in which such deductions should have been properly taken under his method of accounting. If a taxpayer ascertains that a deduction should have been claimed in a prior taxable year, he should, if within the period of limitation, file a claim for credit or refund of any overpayment of tax arising therefrom. Similarly, if a



taxpayer ascertains that a deduction was improperly claimed in a prior taxable year, he should, if within the period of limitation, file an amended return and pay any additional tax due. However, in a going business there are certain overlapping deductions. If these overlapping items do not materially distort income, they may be included in the years in which the taxpayer consistently takes them into account.

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(26 C.F.R., Sec. 1.461-1.)

No. 20915 and No. 20916  
IN THE  
**United States Court of Appeals**  
FOR THE NINTH CIRCUIT

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TIM W. LILLIE and INGEBORG V. LILLIE, husband and  
wife (Docket No. 20915) and PEARL LILLIE, an in-  
dividual (Docket No. 20916),

*Petitioners,*

*vs.*

COMMISSIONER OF INTERNAL REVENUE,

*Respondent.*

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**PETITIONERS' REPLY BRIEF.**

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**FILED**

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**NOV 9 1966**

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---

**PETITIONERS' REPLY BRIEF.**

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**Preliminary Statement.**

This reply brief is necessary to dispel the smoke-  
screen created by Respondent's brief.

To properly utilize the short time permitted for oral  
argument of this case, counsel for both parties and  
this Court must have a clear view of the points in-  
volved prior to hearing. Time and attention at the  
hearing must not be diverted to irrelevant cases and mis-  
statements of the facts and the evidence.

**I.**

**Respondent's Brief Cites Fourteen (14) Cases  
Which Are Irrelevant to Any Issue Before This  
Court.**

Counsel for Petitioners has read and analyzed four-  
teen (14) cases cited in Respondent's brief which are  
not relevant to any issue before this Court. Time at

the hearing of this case should not be spent distinguishing them; therefore this reply brief must do so to assist the Court and permit the Court to focus its attention on the true purpose of the review—to see the errors and mistakes of the Tax Court below.

Respondent's brief (footnote 7 at p. 13) cites six (6) cases as having "considered" the point that the deposits for future services<sup>1</sup> cannot be deducted as expenses in the year of payment. Actually, the cases cited by Respondent are concerned with and hold the following:

1. *Main & McKinney Bldg. Co. v. Comm'er*, 113 F. 2d 81 (C.A. 5th), 40-2 USTC ¶9558.

(Rental payment on 99 year leasehold)

Taxpayer acquired a 99 year lease on real property in Houston, Texas, and attempted to deduct annual payments of rent as ordinary and necessary expense in the year of payment. The Court held that annual payments of rent constituted part of the cost of the leasehold rental payments and were not deductible in their entirety in the years of payment but should be recovered by deductions for exhaustion over the term of the lease.

2. *Baton Coal Co. v. Commissioner*, 51 F. 2d 469 (C.A. 3rd, 1961), 2 USTC ¶788

(Bonus payments disguised as rental payments and capital expenditures)

Taxpayer made bonus payments on lease of coal property and deducted as rental payments

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<sup>1</sup>Respondent assumes the issue, as did the Tax Court below, that payments were deposits and that they were for "future" services and "future" purchases.

in year paid. Held: Payments were “bonuses paid in connection with the attaining of the lease” and should be capitalized and the cost recovered over the life of the asset [lease].

3. *Peters v. Commissioner*, 4 T.C. 1236, Dec. 14, 512

4. *Boylston Market Ass’n v. Commissioner*, 131 F. 2d 966 (1st Cir. 1942), 30 AFTR 512

(Prepaid insurance must be prorated)

These two cases deal with the question of whether or not a cash basis taxpayer can deduct prepayment of insurance premiums. The courts held that prepaid insurance, having a longer life than a taxable year, is a capital expense and should be allocated over the period of the insurance contract.

5. *Galatoire Bros. v. Lines*, 23 F. 2d 676 (C.A. 5, 1928)

(Advance rental payments covering 45 month lease must be amortized)

Taxpayer, a lessee for 45 months (3 years and 9 months) paying 50% of the profits from its business and boarding the lessor and his family during the first year of the lease, was required to prorate the total amount of rent over the life of the lease.

6. *Automatic Fire Alarm Co. v. Comm’er*, 13 BTA 1195, Dec. 4495.

(Advance payment for exclusive franchise)

Taxpayer made an advance payment for the exclusive right to purchase and sell certain



merchandise in certain cities. The court held that advance payments were not deductible in the year of payment where the advance was to be credited against merchandise purchases made in future years where taxpayer was not “required” to make any further purchases.

By citing the above cases, Respondent demonstrates the same lack of grasp of the issues in this case as the Tax Court demonstrated in its decision. Advance rental payment cases, prepaid medical expenses cases, prepaid insurance premium cases, and incorrect characterization of capital expenditure cases are inapplicable to the case at bar because they involve well-recognized exceptions to the general rule that an expense shall be deducted by a cash basis taxpayer in the year of payment. These exceptions have long been considered as a special kind of situation parallel to the amortization of capital expenditures.

Respondent’s brief (footnote 8 at p. 13) cites *General Bancshares Corp. v. Com’r*, 326 F. 2d 712 (C.A. 8, 1964), 61-1 USTC ¶9920, as standing for the proposition that if “an amount is paid as a deposit against future expenses [again assuming the ultimate issue], it does not meet the test of deductibility.” In that case the Court held that costs of issuing stock dividends must be capitalized. Any possible analogy between the case cited and the case at bar escapes counsel for Petitioners.

Respondent’s brief (p. 14) cites seven (7) cases apparently concerned with the issues of “burden of proof” and “each case should be decided upon its own facts.”

These cases are concerned with and hold as follows:

1. *Interstate Transit Lines v. Comm'r*, 319 U.S. 590 (CA-8, 1943), 43-1 USTC ¶9486.

(Deductibility of expenses of illegal operation of subsidiary)

Taxpayer, a Nebraska corporation, operated an interstate bus line between Illinois and California and did intrastate business in most of the states enroute. Because of its foreign incorporation, petitioner was barred under California law from doing intrastate business in California. In an attempt to circumvent the law, petitioner created a subsidiary in California which operated illegally and incurred a deficit which taxpayer attempted to deduct as an ordinary and necessary business expense. The Court held that the deficit was attributable to intrastate business of taxpayer's subsidiary in which taxpayer had no legal right to engage, was not deductible by taxpayer.

2. *E. & J. Gallo Winery v. Commissioner*, 227 F. 2d 699 (CA-9, 1956), 56-1 USTC ¶9101.

(Carryover of unused excess profits credit under World War II Excess Profits Tax Law by surviving corporation of a merger)

Taxpayer was the surviving corporation in a merger of corporations, the merged corporation of which had an unused credit under the World War II Excess Profits Tax Law. The Court held that the surviving corporation may carry forward and deduct in subsequent years the unused credit of the merged corporation under the provisions of §701(c)(3)(B) of the 1939 Code.

3. *Comm'er v. Heininger*, 320 U.S. 467, 44-1 USTC ¶9109.

(Deductibility of attorney's fees and expenses of resisting a fraud order against taxpayer's business)

Attorney's fees and other expenses incurred by taxpayer in litigation pursuant to a fraud order instituted against him by the Post Office Department were held by the Supreme Court of the United States to be deductible from taxpayer's gross income, since the defense of his business and the expenses which it involved were ordinary and necessary within the meaning of §23(a) of the 1936 and 1938 Revenue Acts.

4. *Russell Box Co. v. Comm'er*, 208 F. 2d 452, 454; 54-1 USTC ¶9126 (CA-1, 1954)

(Items not deductible as expenses—wire mesh fence a capital expenditure; losses not deductible on sham sales)

The issues in this case were whether or not the cost of a wire mesh fence around taxpayer's plant was a deductible expense or a capital expenditure, whether an alleged sale of machinery to an employee of taxpayer's selling agent was a bona fide sale and a subsequent loss on the sale deductible, and whether or not the worthlessness of a bad debt had been established to make it deductible. The Court held that the wire mesh fence was a capital expenditure, that the worthlessness of the bad debt had not been established and therefore was not deductible, and that the alleged sale was not a bona fide sale and the loss on it was not deductible.

5. *Wohl v. U.S.*, 267 F. 2d 605 (CA-5, 1959), 3 AFTR 2d 1654 [*Rittenberg v. U.S.*]

(Expenditures by taxpayer on behalf of his corporation to obtain lease for corporation not deductible as rental payments or business expenses)

This case is actually known as *Rittenberg v. United States* and involves a taxpayer who made annual payments, personally, to an owner of an apartment house to induce the owner to lease the land to his corporation at \$9,000.00 per year rather than \$12,000.00 per year as the land owner demanded. The taxpayer deducted the annual payments made by him personally as a business expense. The Court held that the payments were in the nature of “capital contributions” by the taxpayer to the corporation and were not deductible by the taxpayer not only on the theory that the expenditures were made as capital contributions but also because they were made “on behalf of another”.

6. *Wells-Lee v. Comm’r*, TCM 1964-315, 23 TCM Dec. 27073(M)

(Payments by osteopaths to hospital to secure staff privileges are not business expenses but capital expenditures)

This case involved three osteopaths who made payments to a hospital association to secure staff privileges to practice in hospitals owned by the association. The taxpayers deducted such payments as ordinary and necessary business expenses, but the Court held that they were not deductible as ordinary business expense but rather they were capital expenditures.



7. *Doyle v. Mitchell Brothers Co.*, 247 U.S. 179 (1918), 1 USTC ¶17 (CA-6, 1918).

This 1918 case involves a lumber manufacturing corporation which owned certain timber lands which appreciated in value over the years. The issue was whether appreciation in value of assets prior to incidence of tax was taxable income on subsequent liquidation, and the Court held that it was not.

Petitioners submit that the cases cited above are irrelevant to the issues at bar and hesitate to suggest why they have been cited in Respondent's brief.

## II.

### **Respondent's Brief Contains Misstatements of Important Facts and the Evidence.**

Respondent's brief contains several misstatements of facts and the evidence which are so vital in this case that such reckless statements could prejudice a fair review of Petitioner's appeal if not pointed out to this Court prior to the hearing. Petitioners specify the following gross misstatements:

1. Respondent charges (p. 17) that Petitioners failed to report the sale of feed back to McCabe in the so-called "refund" incident of 1961 as income in that year [and cites Ex. 8-H]. The reviewing agent, appellant staff, counsel for Respondent below and the Tax Court were all aware that the money received by Petitioners from McCabe in 1961 is included as income in the item identified as "sale of cattle" on the

schedule of farm income in the 1961 returns of Petitioners. Counsel for Respondent at this level *could have* and *should have* ascertained this fact before including such accusation in its brief.<sup>2</sup>

2. Respondent states (brief p. 18) that “a substantial portion of the end-of-year payments was for services to be rendered in the subsequent year”, yet neither Respondent nor the Tax Court below have any evidence, testimony or idea of what portion of the cost of feed constituted “services” and what portion constitutes “ingredients”.
3. Respondent’s statement (p. 15) that “[all] customers of Heber and McCabe *could* pay monthly for the cost of feed consumed . . .” is simply untrue. The evidence is uncontroverted that Petitioners’ binding agreement with Heber and McCabe was to pay in advance.

By copying the language of the Tax Court decision in its brief, Respondent has compounded the errors and mistakes which occasion this appeal.

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<sup>2</sup>This Court may be assured that the tax audit conducted by the District Director of Internal Revenue in this case did NOT leave \$26,140.57 and \$14,382.74 of overstated cost of feed in 1960 or understated income in 1961 unaccounted for until this point in the proceedings to be suddenly “discovered” by counsel for Respondent.

**Conclusion.**

Petitioners submit that because counsel for Respondent was granted extra time within which to prepare the government's brief, it seems only fair that, prior to the hearing of this case, this Court should consider Respondent's citation of so many irrelevant cases and inclusion of misstatements of facts.

Respectfully submitted,

CHARLES A. PINNEY, JR.,  
*Attorney for Petitioners.*

### **Certificate.**

I certify that, in connection with the preparation of this brief, I have examined Rules 18, 19 and 39 of the United States Court of Appeals for the Ninth Circuit, and that, in my opinion, the foregoing brief is in full compliance with those rules.

CHARLES A. PINNEY, JR.,















